

Global Financial Governance and Export Market-Dependency in the Present Economic Rise of China

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ABSTRACT

This paper argues that the source of China's rise is rooted in the structural transformation of the financial features of 'globalization'. While mainstream theory interprets globalization as various free flows of information, capital, technology and so on, I argue that the dollar standard – i.e. that the United States dollar standard is set as the major medium of the international economy – is the main mechanism to drive globalization. The dollar standard reinforces U.S. financial muscle that makes global economic growth dependent on the U.S. market. As the dollar crisis during the first half of the 1980s induced the structural adjustment of Latin America, it reshaped the regional industrial division of labor in East Asia. This structural transformation channeled huge export-oriented capital into China and thus critically contributed to China's significant development, especially after the 1990s. However, it also brings China the problems of overproduction and dependency on the U.S. market.

Keywords: dollar standard, globalization, East Asian regionalization, dollar cycle, overproduction

China's spectacular development since reform in the late-1970s has attracted the attention of the world. This paper explores two questions: why has China's economy expanded so rapidly, and what are the main challenges to continued future expansion. My argument is that the rise of China has to be understood in the context of the transformation of the financial structure underlying globalization. However, unlike the mainstream interpretation of globalization, I argue that the core dynamic driving globalization is the international monetary system that the United States dominates: the dollar-gold standard and its transition to the dollar standard. The dollar-gold standard from 1945 to 1971 endowed the U.S. with the ability to issue dollars in excess of its gold reserve. The succeeding dollar standard, in which monetary supply is no longer linked to the gold reserve, even further inflates the seigniorage of the dollar for the benefit of the U.S. This financial advantage buttresses the strong purchasing power of the U.S., which is the key factor in cultivating the new deployment of East Asian manufacturing labor, the so-called flying

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geese model, in which the recruitment and deployment of manufacturing labor are successively and quickly disseminated from higher- to lower-labor cost economies.

Although the U.S. is able to utilize its financial advantage to consume global resources far in excess of its output, this consumption relies heavily on the surplus of its financial account financed by its trade partners, which accumulate huge reserves in U.S. dollars. This constitutes a dollar cycle in which dollars are first passed from the U.S. to its trade partners, and then returned back into the financial account of the U.S. through the purchase of U.S. bonds or investments by these trade partners. This dollar cycle inevitably results in the growing indebtedness of the U.S. and the excessive export of dollars, which eventually bring pressure on the dollar for a depreciation and a repayment difficulty for the U.S.

In order to deal with its dollar crisis in the period of the mid-1980s, the U.S. pressed Japan and the "Four Tigers" (the newly industrializing Asian countries: South Korea, Taiwan, Hong Kong, and Singapore) to appreciate their currencies against the dollar. This currency re-alignment reshaped the East Asian production network and channeled huge export-oriented foreign direct investment (FDI) into China, which needed FDI to carry on its reform process. Along with export-oriented FDI pouring in, China also had to import materials, intermediate products and capital goods from Japan and the Four Tigers in order to proceed with its export-oriented industrialization. This induced soaring intra-regional trade and resulted in the so-called Asian regionalization, which is still heavily dependent however on external markets.

Although China has by now accumulated unparalleled international reserves through FDI and its trade surplus with the U.S., China's export-induced development will eventually face problems of currency appreciation similar to those that Japan and the Four Tigers encountered. This is because huge U.S. deficits and debts cannot always be compensated for through the surplus of its financial account. In the long run, the U.S. can improve its deficits only through trade surpluses. Yet this means a structural turn-around of the current world economy. The world will need an alternative market of huge dimensions to replace the role played by the U.S. now. If we consider the international reserve as potential sources of consumption, the East Asian countries, especially Japan and China, will be promising candidates. Nonetheless, this implies that Japan or China will have to reverse current export-induced development to a development dependent more on the domestic market. In other words, a more adequate indicator for the long-term and sustainable rise of China is the simultaneous growth of GDP per capita and the scale of the domestic market. Soaring FDI, trade surpluses, and international reserves are misleading measures of China's progress toward strong and autonomous power, for they cannot escape the potential for impasse inherent to an international economy based on the dollar standard.

THE POLITICAL ECONOMY OF GLOBALIZATION: A PERSPECTIVE OF THE DOLLAR STANDARD

As a buzz word, globalization usually indicates transnational flows of information, capital, technology and commodities around the globe beyond regulation of any individual state. In this section, I propose the institutional change of global finance from dollar-gold standard to dollar standard as the

political economy of globalization. Current transnational flows of commodities, capital and technology are actually induced by the dollar standard and its crisis.

1. *From dollar-gold standard to dollar standard*

The most important task for the core Western states after WWII was to correct the prewar malfunction of the world economy and to reconstruct a stable world economic order so as to ensure economic growth and full employment. In the classical Gold Standard era (1870-1914), the domestic credit system was based on gold and linked with other countries through relatively fixed exchange rates. If a country ran a balance-of-payments deficit, its money supply based on gold would decrease and lead to falling domestic prices. To rectify the balance of payments, this country had to export more and cheaper commodities. Therefore a stable world economy usually circumvented the national economic goals of any particular country, for instance, domestic full employment. "A major consequence of the First World War was a nationalization of the world monetary system."¹ To mobilize their economies for war and domestic needs, states unhooked themselves from the system of fixed exchange rates and set up trade barriers to improve their balance of payments. The economic nationalism in this era ended with the decade of the Depression that prepared the stage for the later Bretton Woods System (BWS) after WWII.

The BWS under the dominance of the core Western countries was intended to alleviate the tension between national development policies and a stable world financial order. This system required that every currency peg its exchange rate to the U.S. dollar, the value of which was fixed at \$35 per ounce of gold. Two organizations were set up to enforce the regulations for an international monetary order and the balance of payments of individual countries. One was the International Monetary Fund (IMF), which oversaw the countries' economic performance and provided "bail-out" loans for countries that experienced balance-of-payments difficulties. Thus countries with short-term deficits would not need to start competitive devaluation or import restrictions like those in the prewar period. The other institution was the World Bank. It provided large-scale loans for national infrastructural projects like dams, highways or power plants, which complemented small-scale private investment.

The exchange rates fixed through the dollar, not gold directly, produced more international financial flexibility compared to the automatic adjustment of the Gold Standard. With the loans from the IMF and World Bank, states had more capacity to carry out their national development in coordination with the world economic system. As Ruggie said, this was the compromise of embedded liberalism. "Unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicted upon domestic interventionism."²

1 Gilpin, Robert. 1987. *The Political Economy of International Relations*. Princeton: Princeton University Press, p.128.

2 Ruggie, John Gerard. 1982. "International Regimes, Transactions, and the Change: Embedded Liberalism in the Postwar Economic Order," *International Organization*, Vol. 36, No. 2, p.393.

Obviously, a stable dollar-gold ratio was the pivot of the BWS. This seemed quite natural at that time since the U.S. held 70% of the world's total financial monetary gold stock in 1947.³ This overwhelmingly high ratio of gold stock supported the dollar as the world currency. Under the BWS, the U.S. had to run a balance-of-payments deficit in order to pump capital into the world economy even though the U.S. already produced one-third of the world's economic output and more than half of the world's manufactured goods in 1945.⁴ While the U.S. could not adjust its exchange rate to improve international trade, this disadvantage was greatly compensated for by the unparalleled advantage it gained in expanding its purchasing power to support its economic, political and military presence abroad. As all other countries had to accumulate dollars to maintain their balance-of-payments, the balance-of-payments deficit of the U.S. was accepted as a necessary condition for the successful functioning of the world economy. The purchasing power of the U.S. could simply be maintained by printing more money, provided other countries still had confidence in the dollar's value. Its robust capacity for material output and capital export provided a foundation for the global U.S. intervention in the postwar development of other countries and established the core foundation of the U.S. hegemony.

However, international economic growth that rested on the U.S. balance-of-payments deficit could not continue this way forever. As offshore dollars gradually approached a level that exceeded the U.S. gold reserves, the commitment of the U.S. to convert dollars into gold would be accordingly damaged. As a matter of fact, official dollars held abroad had already exceeded the U.S. gold stock by over 300 percent by 1971.⁵ To maintain the political and economic autonomy of the U.S., President Nixon rescinded the gold convertibility of the dollar in 1971. The international monetary order, which was based on the fixed exchange rate of the BWS, was deregulated and a period of floating rates began.

Theoretically the dollar was only one of all the national currencies in the world in the period of floating rates. Nevertheless, many national currencies were still fixed to the dollar as it was used most widely. Thus, the decoupling of the dollar and gold actually empowered the U.S. to print dollars to import goods on an even larger scale. The U.S. dollar replaced gold as the main foreign reserve of most countries. The international financial system in fact entered into an epoch of the dollar standard. The U.S. financial account surplus, which reflected its current account deficit, steadily and slowly rose after the 1970s. It "took off" however after 1983 and reached its first peak in 1987. Although this figure shrank to only US\$9.2 billion in 1992, it soon surged to a stunning US\$612.7 billion in 2004 (Figure 1).

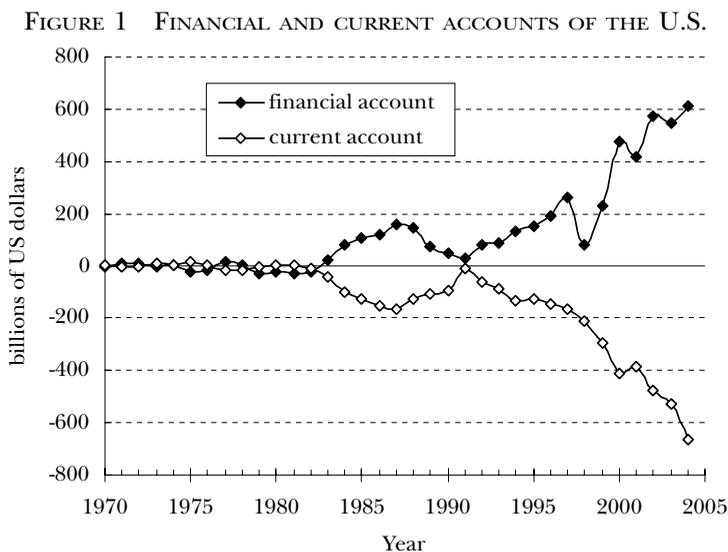
Along with this accelerating accumulation of the financial account surplus in the U.S., total foreign reserves throughout the world shot up correspondingly. They expanded 13 times from 1963 to 1987 and reached 63.7 times in 2004.⁶ This huge growth of international reserves is the direct result

3 Walters, Robert S. and David H. Blake. 1992. *The Politics of Global Economic Relations*. Englewood cliffs: Prentice Hall, p.73.

4 Rapley, John. 1996. *Understanding Development: Theory and Practice in the Third World*. Boulder: Lynne Rienner Publishers.

5 Walters, Robert S. and David H. Blake. 1992. *The Politics of Global Economic Relations*. Englewood cliffs: Prentice Hall, p.75.

6 International Financial Fund, 1998, *International Financial Statistics Yearbook*, Washington D.C., pp. 46-47 and *International Financial Statistics Yearbook 2005*, pp. 24-25.



Source: Data before 1997 are collected from International Financial Statistics Yearbook 1998, pp. 894-895. Data after 1998 are from International Monetary Fund : International Financial Statistics Yearbook 2005, pp. 602-603.

of the continuous export of dollars from the U.S. Exporting dollars is actually a way of borrowing by credit that makes the U.S. consume global resources far above the level of production of the U.S. This financial advantage of the U.S., on the one hand, reinforces its capacity to command material resources globally; on the other, the sustainability of the dollar standard thus becomes a pivotal factor to keep global trade and production functioning well.

In the next section, I argue that the dollar crisis and the response of the U.S. government to the crisis induced the “structural adjustment” of the import-substitution industrialization in Latin American countries and the rise of a much-praised East Asian “economic miracle.” National regulations on trade and investment were deregulated and a freer network for international trade and investment was promoted. “Globalization” then became the buzzword we are familiar with today.

2. *Formation of globalization under the dollar standard*

Floating exchange rates after 1971 and the oil crisis which followed resulted in a structural change in sources of finance for the Latin American countries during their import-substituting industrialization (ISI). On the one hand, the oil crisis increased the supply of cheap credit due to the expansion of petrodollars. On the other hand, the revenues of Latin American countries declined because the recession caused by the oil shock shrank the primary exports from the periphery to the core. To deal with this problem, the second import-substituting industrialization turned out to be necessary in order to carry out more value-added production. Cheap credits from large international commercial banks thus provided the capital that these countries desperately needed.

Peripheral countries also preferred the loans from international commercial banks to finance their national projects. Money from commercial banks was preferred to multilateral loans because they tended to offer easier repay-

ment terms and reduced restrictions over those implemented by the core countries represented in the IMF and World Bank. Their borrowing was also fully welcomed by those First World bankers who believed that countries did not go bankrupt. This reconfigured the debt structure of the periphery. By the early 1970s, multilateral loans accounted for 33 % of total debts and 25 % came from export credits. By 1984, nine of the largest U.S. banks had extended more than 100 percent of their shareholders' equity in loans to Mexico, Brazil, Argentina, and Venezuela. This large-scale capital intake supported the state corporatism of the peripheral countries.⁷

Large scale borrowing was logically consistent with the ISI strategy. Besides, it was not unreasonable on condition that the world economy would keep growing. Unfortunately, the second oil shock impacted again. In order to fight inflation and to attract foreign capital to appease its severe balance-of-payments deficit, the U.S. carried out tight monetary policy during the first half of the eighties through raising interest rates above the world average to their highest level since WWII.⁸ This had a disastrous effect on debt-ridden state economies. On the one hand, the U.S. absorbed capital that was needed to continue the development of the periphery. On the other hand, it erected the highest interest rates in the postwar period so that repayment costs were beyond the capacity of the Third World countries.

As a result, the financial problem of the U.S. was transformed into the debt trap in which many developing countries of Latin America and Africa found themselves. The increasing inability of the indebted countries to meet their debt obligation overturned the myth that countries did not go bankrupt. However, to demand that these states meet their debt obligations was beyond the capacity of private banks, no matter their size. This capital extraction had to rely on political arrangements. The growing inability of the peripheral countries to service their debts finally forced the official BWS institutions, IMF and World Bank, into the role of managing the international monetary order. By 1988, the composition of loans to these less developed countries was 6 percent from private banks in contrast to 88 percent from multilateral loans.⁹

As a result, the IMF and World Bank which were initially founded to aid national development were revived in the 1980s to promote open trade and investment globally. Through the multilateral loans, the BWS institutions implemented their Structural Adjustment Project (SAP), which emphasized export-led growth (trade liberalization and exchange rate reform), improved domestic capital formation (tax and financial reforms), and the reduction of government intervention.¹⁰

The SAP embodied neoclassical thinking. The debt problem was not understood as a structural exploitation inherent to the capitalist world-economy, but simply as a shortage of liquidity. This shortage could be improved

7 McMichael, Philip. 2000. *Development and Social Change: A Global Perspective*. 2nd ed. Thousand Oaks: Pine Forge Press, Pp.118-121.

8 Arrighi, Giovanni. 1994. *The Long Twentieth Century: Money, Power and the Origins of Our Time*. New York: Verso, figure 20.

9 McMichael, Philip. 2000. *Development and Social Change: A Global Perspective*. 2nd ed. Thousand Oaks: Pine Forge Press, Pp. 165.

10 For IMF reform programs from 1983-85, 79% had particular conditions for exchange rate action, 59% for public enterprise privatization and tax reform. For World Bank reform programs between 1982 and 1989, 79% had particular conditions for trade liberalization, 67% for tax reform and 65% for public enterprise privatization. See Gwynne, Robert N. and Cristobal Kay. 1999. *Latin America Transformed: Globalization and Modernity*. London: Arnold, p.78.

by creating trade surpluses through greater participation in the world market. ‘Unnecessary’ spending like social welfare, housing, education and health insurance should be slashed because government spending has squeezed out private investment and has brought in inflation. State-owned enterprises needed to be privatized because they were inefficient and were run by cronies. Currency was devalued to stimulate exports and to enhance national competition by importing foreign capital goods and technology. Regulations on trade, financial and labor markets were to be loosened so as to find a country’s position of “comparative advantages” in the world economy. In this way, roughly 40-50 % of Latin American exports were used to service their debts through the entire 1980s.¹¹ SAP replaced the priority of national development with global market participation. ISI with emphasis on national development was dismantled and the bright performance of East Asia was then praised as a miracle because of its export-oriented development. Another wave of transnational free flows of trade and investment and a reconstruction of the international division of labor were staged and these eventually turned into the phenomena of globalization we understand today.

EAST ASIAN REGIONALIZATION SHAPED BY GLOBALIZATION

The globalization induced by the crisis of the dollar standard presses global deregulation on transnational flows of trade and capital. However, due to different geo-political conditions, this deregulation produces impacts on East Asia which differ from Latin America. Japan and the Four Tigers accumulated huge international reserves during the dollar-gold standard period because of their ‘invited development.’ This capital accumulation empowered Japan and the Four Tigers with stronger financial muscle to deal with fluctuations of the dollar supply in the 1980s.

Sharp currency appreciation since the mid-1980s rapidly pushed East Asia into a reconstruction of the division of labor, which resulted in a peak of intra-regional trade and investment since WWII. The incorporation of China plays a significant role in this regional economic integration. Nevertheless, in terms of a self-sustainable economy, the East Asian integration has at least a basic weakness, that is, its reliance on the U.S. market as final point of consumption. This forces East Asian economies, irrespective of China’s growth, to keep operating under the regulation of the dollar standard.

1. *Flying geese order under dollar-gold standard*

The East Asian export-oriented industrialization applauded by the IMF and World Bank was actually not ‘naturally’ born as a result of a free market, but shaped by the geo-politics of postwar U.S. East Asian policy. The initial goal of the U.S. postwar East Asian policy was to dismantle Japanese imperial militarism so as to guarantee a peaceful, democratic new Japan. The package of reconstruction included taking apart the financial engine for war, the zaibatsu, democratizing the political system and reforming its militaristic culture. However, the emergence of the Cold War confrontation from late 1947 to 1948 changed this project radically. The priority was then no longer Japanese sociopolitical reform, but the balance-of-power in East Asia. Given the deep colonial connections built in the prewar East Asian Co-Prosperity

¹¹ Walters, Robert S. and David H. Blake. 1992. *The Politics of Global Economic Relations*. Englewood cliffs: Prentice Hall, p. 96.

Sphere, restoring this network through its Japanese head would be crucial for the U.S. to check the communist powers in East Asia. Beginning in 1947, Washington and the Supreme Command for the Allied Powers under General MacArthur started to reconstruct Japan as the economic linchpin of Asia within the U.S. anti-communist alliance framework. As Borden said:

This "reverse course" enabled traditional Japanese business bureaucrats and political elites to remain entrenched in political power and ended the attempt to diversify ownership of industry. By 1949 the United States instituted a full-blown "Japanese recovery program," which closely paralleled the European Recovery Program (otherwise known as the Marshall Plan).¹²

The basic economic operation of this 'Asian Marshall Plan' is similar to its European counterpart. In the Marshall plan, the U.S. exported dollars to start the economic self-reliance of Western Europe. To cover the problem of dollar shortage due to importing U.S. technology and consumer goods, Western European states exported manufacturing goods to their former colonies, which in turn completed the cycle by exporting raw materials to the U.S. In the East Asian case, Japan was chosen as the linchpin to integrate the regional economy. As the only industrial power in the region before the war, Japan was given access to raw materials in Southeast Asia and encouraged to export capital goods and manufactured products to the other East Asian countries. The U.S. then pumped dollars into this region by importing these countries' exports.

The most popular pattern used to explain this division of labor in East Asia is the so-called flying geese model. It subtly connects two parts together: the domestic transformation of industrial sectors from high value-added to low value-added ones, and transnational linkage of production through relocating low value-added production to the areas with proper comparative advantages. When the term was first coined by Akamatsu Kaname in the late 1930s, it was used to explain how national economies moved from the "underdeveloped" stage to the "advanced" stage by the developmental cycle of their leading industrial sector. Akamatsu suggested that less industrialized countries would experience three stages from importing capital goods, through to establishing domestic homogeneous industries, to finally exporting the previous imports. Each stage overlapped to some extent like geese flying in an inverse V shape.

The transnational movement of production comes from Raymond Vernon's interpretation of the product life-cycle theory. In the first place, the concept of the product life-cycle projects a series of stages through which the sales volume for a product changes from initial innovation (very few buyers), to growth (growing number of buyers), to mature (peak demand), decline (declining demand), and finally to obsolescence (steep fall-off in demand). Vernon adds a locational connotation to this product life-cycle concept to explain the movement of international production. Based on the U.S. case, he suggests that product innovations should occur first in the U.S., to be later exported to other high-income markets like those in Europe. In time, off-shore production will be established because of production and distribution costs or import tariffs. Along with the production going from innovation to maturity, the European production sites will not only serve local markets but also start to export to the third countries. Finally, when production technology had been standardized, products will become more price-sensitive and

¹² Borden, William S. 1984. *The Pacific Alliance: United States Foreign Economic Policy and Japanese Trade Recovery, 1947-1955*. Madison: the University of Wisconsin Press, p.3.

their production will necessarily move to countries with lower labor costs. These will begin to export the products back to the U.S. and European markets.¹³

Through the work of Ipppei Yamazawa, Saburo Okita and Kojima Kiyoshi, the synthesis of the flying geese pattern and production life cycle is constructed as a rational and mutually beneficial division of labor under Japan's regional leadership. Kojima even distinguishes Japanese-style direct foreign investment from the (U.S. and European) MNC-style investment. The MNC-styled investment, he argues, attempts to achieve monopolistic gains by dominating the host country's domestic market. Investing countries thus can easily expand exports and exclude the national interest of the host countries. On the contrary, Japanese DFI is development-oriented and more helpful to the host country.¹⁴

As South Korea and Taiwan are considered the successful late comers by following the Japanese pathway, the achievement of Northeast Asia thus becomes strong evidence to support the flying-geese model. In this model, Japan produces the highest value-added exports by 'the principle of comparative advantages' due to its superiority of capital and technology. Due to the degree of capital- and technology-intensity, Japan is able to export its innovative goods to the second-tier countries (South Korea, Taiwan, Hong Kong, Singapore). These Asian Tigers then continue a cascade of capital and technology to the third tier (Malaysia, Thailand, the Philippines, and Indonesia) and eventually to the fourth tier (China, Vietnam, and perhaps, India).

However, if Japan is the leading goose for the East Asian production network, the flight direction is actually guided by the U.S. purchasing power. Without the U.S. market, no goose can complete its capital accumulation, no matter how effective the flexible East Asian production network within which they function. Before the Plaza Accord of 1985 which structurally changed the East Asian division of labor, the percentage of exports to the U.S. from Japan and the Four Tigers grew in relation to the rise of the U.S. financial account. This ratio reached its peak of around 35% to 40% in the mid-1980s,¹⁵ and has now reappeared in exports by China. In the next section, I will argue that this transformation is induced by the financial fluctuation of the dollar standard. A global financial structure which pivots on the dollar standard has a basic limitation, that is, the dollar has to be devalued when dollar exports reach a certain unsustainable level. It is this adjustment that induced the transformation of the flying geese structure during the latter half of the 1980s and China's integration into the East Asian EOI pattern since the 1990s.

13 Dicken, Peter. 1998. *Global Shift: Transforming the World Economy*. Third edition. New York: Guilford Press, Pp.161-162; 181-184.

14 Kojima emphasized the relations of mutual benefit and harmony the Japan FDI would bring about for host countries, "Potential comparative advantage that the host country possesses has not been realized because of its lack of technology, capital, and management skills. DFI will assist the host country in realizing its potential, consequently allowing these new industries to grow into export industries. In the meantime Japan develops a new comparative-advantage industry, into which labor and capital are to be transferred from the industries that have expanded overseas. Thus, the structural adjustment is facilitated at home. The industrial structures of both Japan and the host country are improved through this process, expanding harmoniously trade between them, which is more complementary and more profitable than it would have been without the direct investment." See Kojima, Kiyoshi, 1986, "Japanese-Style Direct Foreign Investment." *Japanese Economic Studies* 14 (Spring).

15 Kwan, C. H. 1994. *Economic Interdependence in the Asia-Pacific Region*. London: Routledge, p102.

2. *Reconstructing regional division of labor and China's integration under the dollar standard*

As discussed above, East Asian 'export-induced growth' heavily relies on a huge trade surplus earned from the U.S. The trade surplus in the form of dollars will be exchanged into national currencies to enter these countries. It thus produces two interrelated consequences. First, the central banks of the countries with extensive dollar reserves on hand will look for proper investment opportunities. Following an evaluation of security and liquidity, these countries will purchase the U.S. agents' debt, stock, and corporate bonds. This surplus of financial account enables the U.S. to finance its trade and budget deficits and to maintain the purchasing power that pushes the global economy.

Second, as the dollar surpluses are converted into their own currencies, they will raise the supply of currency and function just like high power money that creates credit expansion through the banking system. This credit expansion will likely boost investment to a level of overproduction that relies on the U.S. market to absorb it.¹⁶ In other words, the U.S. exports dollars in order to exchange commodities from trade partners; these then pump back dollars into the U.S. in order to finance purchasing power sufficient to sustain the economic growth of the U.S. trade partners. This special financial position forces the U.S. to consume global resources through a method of borrowing.

The dynamics of this dollar cycle is sustained by the growing debts of the U.S. Due to the export of excessive numbers of dollars, this cycle will eventually create the pressure for dollar depreciation and cause repayment difficulty for the U.S. For those countries depending on export-induced growth, dollar depreciation means an appreciation of their currency and a lowering of the export ratio to the US market. Those countries then have to enhance their capital export and search for alternative markets. This is exactly what happened in East Asia around the mid-1980s. As the surplus of the U.S. financial account accelerated after 1983 and reached its first peak in 1987, large debts pressed the Regan Administration to demand currency appreciation by trade partners against the dollar in order to boost U.S. exports and cut down the deficit. This resulted in the Plaza Accord.

Japan and the four tigers appreciated their currencies from the latter half of the 1980s to 1995. Three years after the Tiananmen incident, China decided to sustain its economic reform and depreciated the Renminbi against the dollar to boost exports and attract foreign investment (table 1). Therefore, the pressure of a dollar depreciation which gathered under the dollar standard dominated by the U.S. first triggered a regional alignment of exchange rates, which then induced a transformation of the regional reconstruction of the division of industrial labor. In other words, the integration of East Asian economies is not pushed by a globalized 'factor price equalization theorem' as the popular neo-classic perspective argues, but is a compounded outcome shaped by the hegemony of the dollar standard and individual countries' strategies to pursue their national interests.

16 Indeed, the central bank can absorb extra money by issuing bonds. However, this instrument will be impractical if the interest rates of bonds rise too high because reserve flows in too much or too quickly. The other policy option for the central bank is to sell dollars through the open market. Yet, this will press currency appreciation of the country. For a country that pursues export-induced growth, this is an option it tries to avoid by all means.

TABLE 1 EXCHANGE RATE OF FOUR TIGERS AND CHINA (BY DOLLAR),
1986-1998

Year	Hong Kong Dollar	Singapore Dollar	Won	New Taiwan Dollar	Renminbi
1986	7.803	2.177	881.45	37.838	3.453
1987	7.798	2.106	822.57	31.740	3.722
1988	7.806	2.012	731.47	28.588	3.722
1989	7.800	1.950	671.46	26.407	3.765
1990	7.789	1.813	707.76	26.893	4.783
1991	7.771	1.728	733.35	26.815	5.323
1992	7.741	1.629	780.65	25.164	5.515
1993	7.736	1.616	802.67	26.387	5.762
1994	7.728	1.527	803.45	26.457	8.619
1995	7.736	1.417	771.27	26.486	8.351
1996	7.734	1.410	804.45	27.458	8.314
1997	7.742	1.485	951.29	28.703	8.290
1998	7.745	1.674	1401.44	33.456	8.279

Source: Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries, 1999.

Currency appreciation by Japan and the Four Tigers (except Hong Kong¹⁷) depressed export profits and drove the labor intensive sector to seek cheaper labor. After the mid-1980s, Japan increased its investment in the Four Tigers and later turned to Southeast Asia and China in the 1990s.¹⁸ The Four Tigers also rapidly raised their investment in China around 1991-1993. As this wave of FDI was fuelled by the search for cheaper off-shore production bases, it consequently generated demand for the import of materials and capital goods by host countries. The direct result was an increasing in intra-regional trade in the appearance of the East Asian economic regionalization.

This huge FDI flowing into China during the 1990s is usually called a phenomenon of 'globalization', which is always interpreted by the neo-classic theory of factor price equalization. However, statistics clearly demonstrate that flows of postwar global FDI have been distributed according to a strong hierarchy, rather than, as anticipated, according to the factor price equalization theory. From 1960 to 1994, 97.88% of outward FDI stocks flowed out from developed countries.¹⁹ On average, three quarters of this international capital flowed back to developed countries.²⁰ By 2004, stocks of outward FDI from developed countries have declined to 88.47% and 72.73% flowed back into developed countries.²¹

17 Since the Hong Kong dollar is pegged to the US dollar, it actually depreciated against other East Asian currencies during this period. However, as the Renminbi depreciated to an even larger extent, plus Hong Kong's geographic and historic relationship with China, Hong Kong's investment in China presents a similar pattern to other Asian Tigers, but on a much larger scale.

18 Kwan, C. H. 1994. *Economic Interdependence in the Asia-Pacific Region*. London: Routledge, p.102. Even so, we should take note here that over 60% of Japanese FDI is still concentrated in the U.S. and Europe.

19 Developed countries here refer to the U.S., France, Germany, Netherlands, Sweden, Switzerland, the U.K. and Japan.

20 Held, David, Anthony G. McGrew, David Goldblatt and Jonathan Perraton. 1999. *Global Transformation: Politics, Economics and Culture*. Stanford: Stanford University Press, Pp. 247-249.

21 United Nations Conference on Trade and Development. 2005. World Investment Report. New York and Geneva: United Nation Publications, Pp. 257-296.

These numbers remind us of two points. First, transnational capital flows are basically a game for developed countries. Second, however, the period of 1994-2004 does show that developing countries have increased their contribution up to 9.41% of outward FDI stocks. This is also the period that China rapidly sucked in huge amounts of foreign capital. All this seems to be evidence to support capital globalization, though it is still limited to a very moderate range.

As a matter of fact, those new providers of transnational capital are concentrated in the Four Tigers, which account for 69.1% of outward FDI in developing countries.²² In other words, the moderate decentralization of transnational capital from developed to developing countries does not reflect a globalized free flow of capital, but the rise of the Four Tigers in the world hierarchy. This rise has its significance in explaining the high ratio of FDI into China. If we take the investment intensity index²³ during 1990-1998 as an example, the first six countries are the Philippines, Hong Kong, Taiwan, Thailand, Singapore and South Korea. The U.S. ranks only the 33rd and Japan, 87th.²⁴ If data for Philippines and Thailand are discounted because of their small numbers in absolute terms,²⁵ the high ratio of FDI pouring into China is actually not the result of capital globalization, but capital export by the Four Tigers.

Therefore, the Four Tigers are the main source of China's FDI. The reasons for the Four Tigers to export capital come from (1) "flying geese" shaped by the U.S. that helps the Four Tigers to accumulate capital more rapidly than other developing countries; (2) the exchange rate re-alignment which was first used to cope with the crisis of the dollar in the mid-1980s. Both of them are the consequences of an over-supply of dollars under the dollar standard. However, even though the East Asian countries have carried out an effective reconstruction of their division of labor, the dynamic to pull this region's growth still relies on a trade surplus from the U.S. market, which is always ranked in the top three export markets for all East and Southeast Asian countries.²⁶ Hence, when China receives export-oriented investment from the Four Tigers, its development is also tied into the structural constraints inscribed in flying geese: dependency on the U.S. market and an excessive reserve of dollars.

22 This percentage is recalculated from World Investment Report 2005, Annex B.

23 The equation of investment intensity index is as follows:

$$\frac{I_{ij}}{I_{ij}} / \frac{I_{i*}}{I_{i*}} * 100$$

, in which I_{ij} means investment of source country i in host country j . I_{i*} = investment from the world in j . I_{i*} = investment from i in the world. I_{**} = total investment in the world. See Organization for Economic Co-operation and Development. 2002. *China in the World Economy: the Domestic Policy Challenges*. OECD Publications, p. 342.

24 Organization for Economic Co-operation and Development. 2002. *China in the World Economy: the Domestic Policy Challenges*. OECD Publications, Pp. 343-345.

25 Take 2004 for an example, even if investment in China from Virgin and Cayman islands is excluded, the amount of Philippine's investment in China only reached 1.2% of Hong Kong's and 7.5% of Taiwan's. Thailand's proportion was only 0.9% of Hong Kong's and 5.7% of Taiwan's. National Bureau of Statistics of China. 2005. *China Statistical Yearbook 2005*. Beijing: China Statistics Press.

26 http://www.wto.org/english/res_e/statis_e/statis_e.htm.

THE OPPORTUNITY AND CHALLENGE OF CHINA'S RISE

Coinciding with the transformation of the flying geese production network during the mid-1980s to 1990s, China altered its developmental strategy from ISI to a more export-oriented pattern. This reset of developmental strategy achieved significant success in terms of a steadily growing GDP and rapid annual growth in trade surplus and foreign reserve levels (table 2). However, it also imposes some constraints on China's future development.

TABLE 2 INDICATORS OF CHINESE ECONOMIC DEVELOPMENT, 1978-2004

Year	FDI (100 million of US dollars)	Trade/GDP (%)	Trade Balance/ GDP (%)	Foreign Reserve (100 million of US dollars)	GDP growth (1978=100)
1978	—	0.0980	-0.0055	1.67	100.0
1979	—	—	—	8.40	107.6
1980	—	0.1262	-0.0061	-12.96	116.0
1981	—	—	—	27.08	122.1
1982	—	—	—	69.86	133.1
1983	—	—	—	89.01	147.6
1984	—	—	—	82.20	170.0
1985	16.58	0.2305	-0.0501	26.44	192.9
1986	—	—	—	20.72	210.0
1987	—	—	—	29.23	234.3
1988	—	—	—	33.72	260.7
1989	33.92	0.2458	-0.0144	55.50	271.3
1990	34.87	0.2998	0.0222	110.93	281.7
1991	43.66	0.3343	0.0198	217.12	307.6
1992	110.07	0.3424	0.0087	194.43	351.4
1993	275.15	0.3254	-0.0203	211.99	398.8
1994	337.67	0.4359	0.0099	516.20	449.3
1995	375.21	0.4019	0.0240	735.97	496.5
1996	417.25	0.3555	0.0150	1050.49	544.1
1997	452.57	0.3622	0.0450	1398.90	592.2
1998	454.63	0.3427	0.0459	1449.60	638.5
1999	403.19	0.3643	0.0295	1546.75	684.1
2000	407.15	0.4390	0.0223	1655.74	738.8
2001	468.78	0.4335	0.0192	2121.65	794.2
2002	527.43	0.4903	0.0240	2864.07	860.1
2003	535.05	0.6004	0.0178	4032.51	941.8
2004	606.30	0.6980	0.0195	6099.32	1031.3

Source: Chinese Statistical Yearbook, 1984-2005.

As a matter of fact, like many postwar socialist countries, China during Mao's era carried out a typical import-substituting heavy industrialization rather than an export-oriented development. Through the transfer of a huge agricultural surplus, the Chinese government hoped that a national heavy industrial system would be quickly established; this would then provide cheaper capital goods for the anticipated development of agricultural mechanization and light industrialization. As a consequence, the industrial growth rate became the national goal which the agricultural output had to support. The rate of investment rose from the prewar level of 5% to more than 20% on average. This was almost twice that of India's during the 1950s and reached the peak level of Stalin's forced-draft industrialization program in 1928. Ninety percent of the investment was channeled to big capital-intensive

state-owned enterprises that produced industrial capital goods instead of going to the agricultural sector or to consumption.²⁷

Although the Chinese planned economy achieved an approximate annual 10 percent industrial growth rate from 1949 to 1980, this high growth eventually faced a bottleneck. During the period from 1951-1980, the average annual increase of total investment in industrial fixed assets (11.7%) exceeded the annual growth of industrial and agricultural output value (8.6%). The total factor productivity (the gross value of output produced for every unit of labor and capital) actually declined at an annual rate of 2.75% between 1950 and 1979. The Chinese command economy had turned into "self-consuming growth", in which industrial growth ate up an ever larger share of output.²⁸

After winning against his competitor in the crucial Third Plenum of the Eleventh Communist Party Central Committee held in 1978, Deng Xiaoping took advantage of his success to attract substantial bureaucratic support for his reform ideas. Planned heavy industrial growth was scaled down to 7.9%, lower than the growth rate of light industry (8.3%). Investment in heavy industry was cut back from 54.7 % of the total in 1978 to 46.8 % in 1979.²⁹ Resources saved were redirected to the agricultural sector and the production of consumer goods. It was during this period of heightened political struggle that the rural household responsibility system was allowed to revive.³⁰

To correct the flaws of Maoist heavy industrialization, the government also promoted a more reasonable price for grain procurement. These two advantages brought a striking harvest and cash income increase in the rural areas. In addition, to settle the problems of surplus rural labor and investment reduction, the state allowed peasants to develop some "sidelines" as seen in the appearance of "specialized households," which gradually expanded into township and village enterprises (TVEs) in collaboration with local governments.

The real target of the economic reform that the party-state paid attention to during the 1980s was state-owned enterprises, which were the source of major industrial output and state revenue. However, as a radical and comprehensive reform of state-owned enterprises would involve deeper and more complicated problems like tax, price, financial and fiscal overhaul, such a comprehensive reform was simply not in the minds of the top leaders in the early stage. Therefore, the dramatic prosperity of TVEs in the latter half of

27 Lardy, Nicholas R. 1987. Economic Recovery and the 1st Five-Year Plan. In Dennis Twitchett and John K. Fairbank (eds.) *The Cambridge History of China*. Volume. 14, Pp.157-158.

28 Shirk, Susan L. 1993. *The Political Logic of Economic Reform in China*. Berkeley and Los Angeles: University of California Press, p.27.

29 Perkins, Dwight H. 1991. "China's Economic Policy and Performance." In MacFaquhar, Roderick and John K. Fairbank (eds.) 1987. *The Cambridge History of China. Volume. 14: The People's Republic, Part I: The Emergence of Revolutionary China 1949-1965*, p.498.

30 In the household responsibility system the state distributes land to individual households which are responsible for a fixed amount of grain submitted to the state. This system always acted as an effective way to compensate for the overhasty pace of Maoist heavy industrialization and its related collectivization since the Agricultural Producer Collectives in 1955 and the mass starvation of the countryside in the Great Leap Forward during the late 1950s and early 1960s. As this policy received support from many party and government officials, including Deng Xiaoping and Chen Yun, it was severely suppressed by Mao as "rightism."

the eighties brought an unexpected opportunity for the central planners to carry on reform.³¹

The mushrooming of the TVEs during the latter half of the eighties that accounted for an important part of Chinese economic growth had several characteristics. Basically, the areas with thriving rural industrialization are extensions of urban industry because urban enterprises often had to go to their surrounding countryside to find land and workers or simply subcontracted work to rural collective units. The typical examples include the southern tier of Jiangsu surrounding Shanghai and Guangzhou-Foshan in the south of Guangdong. In 1987, 77% of the TVEs, below-village cooperatives and private enterprises were concentrated in the urban-influenced regions. They accounted for 87% of total non-state sector industrial output. In 1988, three coastal provinces, with 17% of China's rural population, accounted for half of all TVEs industrial output. About 60-80% of rural output was produced by firms subcontracting from large urban factories. Rural industrialization through the emergence of the TVEs is better seen as part of the expansion of coastal urbanization as opposed to one of rural industrialization, independent of what is going on in cities.³²

As the main orientation of economic reform was to re-channel resources from heavy industry to light industry and shift the self-sufficient wartime economy to attract foreign trade and investment, it was not surprising that the coastal region was chosen as the initial target because of its traditional advantages of experienced and knowledgeable managers, skillful workers, and well-developed infrastructure. In addition, to pump more than half of total state investment into the coastal region, the government also provided a preferential tax policy for some "experimental spots." The experiment was then expanded to other areas if the outcome was considered positive. In 1980 these spots began with four Special Economic Zones (SEZs), three in the south part of Guangdong close to Hong Kong, plus one in Xiamen in southern Fujian. In 1984 the government expanded the Coastal Open Cities to fourteen other cities from the south to the north. From 1984 to 1993, more zones like the Economic and Technological Development Zones, Coastal Economic Open Zones and Customs-Free Zones, were set up along with the coastal areas. To attract foreign investment to these spots, the government granted these areas special autonomy including the authority to approve investment projects, the freedom to grant tax concessions to foreign investors, and the right to retain a high portion of earned foreign exchange.³³

Another factor to strengthen the advantage of the coastal region was its more independent fiscal ability following the period of reform. The profit retention and tax-contracting system especially empowered the fiscal capacity of the rich coastal governments, as we can see at this point in their growth of extra-budgetary revenue mentioned above. Since 1984 capital-surplus provinces have dramatically reduced their capital exports to poor provinces. By

31 As Deng said, "the greatest success that we never anticipated was the development of the TVEs." See Deng, Xiaoping, 1993, *Selected Works of Deng Xiaoping [Deng Xiaoping Wenxuan]*, Volume III, Beijing: People's Press, p.64.

32 Naughton, Barry. 1995. *Growing Out of the Plan: Chinese Economic Reform, 1978-1993*. Cambridge: Cambridge University Press, Pp.154-155; Perkins, Dwight H. 1990. "The Influence of Economic Reforms on China's Urbanization." In R. Yin-Wang Kwok, William L. Parish, and Anthony Gar-On Yeh with Xu Xueqiang (eds.) 1990. *Chinese Urban Reform: What Model Now?* New York: M. E. Sharpe.

33 Wang, Shaoguang and Hu, Angang. 1999. *The Political Economy of Uneven Development: the Case of Taiwan*. New York: M.E. Sharpe, Pp.177-178.

the early 1990s, no province, except Shanghai, exported more than 10 percent of its GDP to another province. Local capital was used to invest in their own area in order to promote local infrastructure, market size, preferential policy and finally to attract more foreign capital through all these local means.³⁴ The combination of state preferential strategy and local developmentalism attracted foreign investment that was looking for opportunities to access the huge Chinese market. As a result, from the 1970s to the mid-1990s, the coastal region attracted 85% of FDI, while only 1% of FDI went to the western region.³⁵ Therefore, when the East Asian investment cascade touched off by the Plaza Accord finally reached China, an internal structure had been established to cater to incoming foreign capital.

This is why the transformation of the flying geese production network could quickly incorporate China into export-induced development and shift the original export dependency on the US market from Japan and the Four Tigers to China.³⁶ According to U.S. data, China's exports to the U.S. reached 42% of China's total exports in 1999, and the ratio still stays at the level of one-third in 2004.³⁷ As we can see in table 2, China's economic achievement after 1990 is clearly related to its foreign trade and FDI. If China still keeps this export-induced development, the purchasing power of the U.S. market will be a crucial factor. This invites us to ask if China will face the basic problem of past flying geese countries: the impact of the dollar standard.

East Asian countries that depend on export-oriented growth usually receive huge dollar inflows, which are converted into their domestic currencies. This will produce two interconnected phenomena. First, East Asian countries will need to find a secure and profitable place to invest their reserve. Relatively speaking, the US treasury bonds are ideal investment targets. The US thus acquires extra resource to finance purchasing power that absorbs East Asian exports. Second, for East Asian countries, increasing national currencies converted from dollar inflows will pump into domestic economies like high-power currency, which produces multiplier effects and over-investment and overproduction. Overproduction of East Asian countries in turn asks for a bigger export market and eventually enhances their dependency on the US market as the last resort.

In other words, the US exchanges commodities from East Asian countries by printing dollars which flow back to purchase the US treasury bonds. I call this phenomenon "the dollar cycle." This cycle is the main cause of global trade imbalance: extraordinary US debts and the same extraordinary foreign reserve in Japan, four tigers and China. When this trade imbalance develops

34 Ibid, Pp.143-165.

35 Wei, Yehua Dennis. 2000. *Regional Development in China*. New York: Routledge, p.89.

36 The rise of Chinese economy has many reasons including international and domestic factors. Here we mainly concentrate on the international regulation set by dollar standard. Nevertheless, many domestic factors also play crucial role. One of them is the thesis of local state corporatism proposed by Jean Oi (1992). This perspective argues that Chinese significant growth is benefited by financial de-regulation initiated by the central government. Many local governments seize this opportunity and develop profitable local enterprises with full force. With cheap labor from rural area, they together create a proper domestic niche for export-oriented industry.

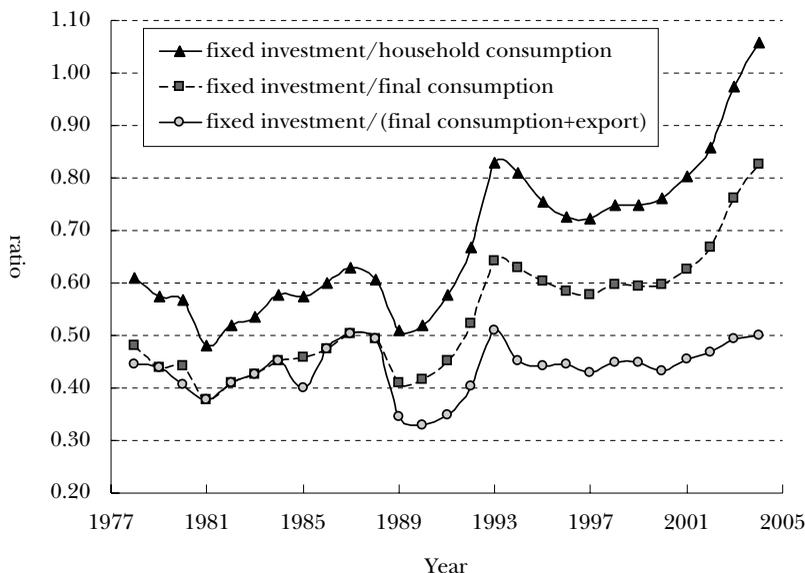
37 Here the total amount of China's export to the U.S. includes part of transit export via Hong Kong. The reason is that the economic scale of Hong Kong apparently cannot absorb so much Chinese export. Please refer to U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, Washington, D.C. 20233. <<http://www.census.gov/foreign-trade/balance/c5700.html#2006>>.

to an 'intolerable' level, it will need to be pulled back by quickly depreciating dollar. The Plaza Accord in 1986 is a typical case, the effects of which severely hit Japanese economy. In this perspective, China will inevitably face a wave of Renminbi appreciation in the foreseeable future due to its unprecedented foreign reserve. This appreciation will definitely promote China's power of FDI, it however will also aggravate the pressures of inflation and overproduction.

China's export-induced development is clear in table 2. Foreign reserve is piling up along with its trade surplus. On the one hand, it results in a rising currency supply, over-investment and over-production; on the other hand, it is accumulating the force to appreciate Renminbi against the dollar. In this pattern of export-induced growth, the rising production capacity of China relies on rising purchasing power of the U.S., which is losing momentum as the surplus of financial account is piling up.³⁸ If China continues on this development course, it could run into a crisis of over-production.

Over-production is reached when purchasing power cannot consume all of the commodities produced by previous investment. If the ratio of fixed capital formation divided by consumption keeps rising in an economy, we may say that this economy is accumulating the pressure of over-production. Therefore, we can observe whether over-production is beginning to take place in China by indicators of its fixed capital formation divided by those of consumption through the period of reform.

FIGURE 2 EXPORT MARKET DEPENDENCY OF CHINA



Source: Chinese Statistical Yearbook, 1984-2005.

38 Although the U.S. current account deficit shrank during 1986-1990 due to the conclusion of the Plaza Accord, it started another much larger wave of deficit growth after 1990. According to the statistics of the WTO, the U.S. deficit had reached 668.08 billions by 2004, which means the U.S. imported commodities from the world by printing over seventy-six millions notes every hour. <<http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=&Country=us.>>

We first divide the total amount of fixed capital formation by household consumption expenditure. The tendency is clearly going up. Second, we add government spending, that is, fixed capital formation divided by household plus government consumption expenditure. The tendency is parallel to the first one except that the ratio is smaller as the denominator is larger. Only when we divide fixed capital formation by total domestic consumption expenditure plus exports, can China's productive capacity and consumption be balanced (figure 2). This means that China has to actualize its profits through the world market, in which U.S. consumption accounts for a significant share. Without the U.S. market, the problem of overproduction in China will bring strong pressure for deflation in China's economy. For this reason, China must continue to purchase U.S. bonds in order to finance U.S. consumption, just as Japan and the Four Tigers did earlier.

CONCLUSION

The huge deficits and debts of the U.S. cannot always be compensated for through the surplus of its financial account. In the long run, the U.S. can improve its deficits only through a trade surplus. Yet this means a structural turn-around of the current world economy. The world will need an alternative large market to recast the role currently played by the U.S. If we can take international reserves as potential consumption, the East Asian countries, especially Japan and China, will be promising candidates. Nonetheless, this implies that Japan or China will need to reverse current export-induced development to a development dependent more on their domestic market. In other words, a more adequate indicator for the rise of China is the simultaneous growth of GDP per capita and domestic market scale. Simply stressing a soaring FDI, trade surplus or international reserve could be misleading when measuring China's progress to being a strong power - they actually imply potential difficulties for China's development under the dollar standard.