

Balance Growth Distribution to Achieve Better Social Development: A Reflection on China's Urban  
Centered Export-Oriented Industrialization Strategy

By  
Xiaoyan Song

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Approved: Dr. Anthony O'Malley  
Supervisor

Approved: Dr. Charles Beaupre  
Reader

Approved: Dr. Xiaoping Sun  
Examiner

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**Abstract**

Inequality has been rising since China's economic reform. This thesis analyzes inequality in terms of urban-rural income differences that caused by the combination work of global forces and national policies. In particular, China's adoption of export-oriented growth based explicitly on wage competitiveness. This cannot be fully explained by its controlled exchange rate policies and even huge surplus of rural labor. It is a consequence of the government's fiscal, financial, and agricultural policies that transferred financial and human resources from its rural-agricultural sector to the urban-industrial sector. As rural population account for the majority of the entire population, a drop of wage share for the rural population lead to falling private consumption and aggregate demand. A weak domestic market automatically made China overly dependent on foreign demand thus exposed China to the unstable situations of international market. The paper concludes that the government should dedicate efforts to build a strong domestic market by adopting a more inward economic strategy that focuses on boosting domestic incomes for the poorer in order to achieve more balanced development.

April, 2017

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## Table of Contents

Chapter 1. Introduction .....	1
Chapter 2. Literature Review: China's Urban Centered Export-oriented Growth .....	5
2.1. Reform background .....	5
2.1.1. Pre-reform era: The failure to adopt the Soviet model .....	5
2.1.2. China in reform .....	14
2.1.3. Why "let some people get rich first": The validity of urban centered export-led industrialization strategy in China and the theoretical support for the Chinese reform .....	17
2.2. Export-Oriented Industrialization (EOI) .....	33
2.2.1. Origin of the Theory .....	33
2.2.2. The controversy: virtues vs. limits .....	35
2.3. China's urban centered export-oriented growth .....	45
2.3.1 The transition to an export-oriented economy has contributed to China's economic leap .....	46
2.3.2. Necessity for the transformation of China's urban centered export-oriented economy .....	48
2.3.3. Transformation approach suggestions on China's export-oriented economy .....	56
Chapter 3. Data Analysis .....	59
3.1. The size of China's rural population .....	61
3.1.1. Rural and urban division .....	61
3.1.2. Rural and urban population .....	63
3.2. Economics of domestic consumption vs. exports in GDP growth .....	65
3.3. China's urban centered export oriented growth .....	67
3.3.1. Domestic consumption power is still not driver of growth .....	67
3.3.2. Trade and China's Economic Growth .....	70
3.3.3. Sources of China's urban-centered and export-oriented growth .....	73
3.4. Further problems .....	83

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Chapter 4. Discussion and Conclusion .....	86
4.1. Summary of findings .....	86
4.1.1. The issue of inequality .....	86
4.1.2. China's export and growth.....	88
4.1.3. China's consumption and growth .....	93
4.2. What remains in question.....	96
4.3. Conclusion.....	100
Appendix 1. Urban and rural income inequality, 1978–2011(Gini coefficients) .....	103
Bibliography .....	105

**List of Tables**

Table 1. Population and its composition (NBSC, 2015) .....	63
Table 2. Floating population in China(NBSC, 2015) .....	64
Table 3. GDP Composition Using Expenditure method(Government of China, 2013) .....	68

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### List of Figures

Figure 1. Arguments supporting the new consensus on openness.....	36
Figure 2. Concept map of Chinese city composition(Chen J. , 2010) .....	62
Figure 3. Average Annual GDP Growth Rate of China (2005 US Dollars; % change per annum)(UNESCAP, 2016) .....	71
Figure 4. Average hourly compensation costs of manufacturing employees, selected economies and regions, 2002-2009.....	74
Figure 5. Employees in the manufacturing sector, selected economies, 2002-2009 .....	74
Figure 6. China, Labor Productivity vs. Real Wages in Industry, 2000-2013(Lim, 2014).....	75
Figure 7. China’s urban - rural real income ratio(Lu & Zhu, 2015) .....	77

### Glossary of Terms

CCP	- China Communist Party
EOI	- Export-oriented Industrialization
FDI	- Foreign Direct Investment
GSC	- Global Supply Chain
Hukou	- Household Registry System of China
IMF	- International Monetary Foundation
ISI	- Import Substitution Industrialization
LDC	- Less Developed Countries
MOC	- China's Ministry of Commerce
PRC	- People's Republic of China
SEZ	- Special Economic Zones
SOE	- State Owned Enterprises
UN	- United Nations
WB	- World Bank
WTO	- World Trade Organization

# Balance Growth Distribution to Achieve Better Social Development: A Reflection on China's Urban Centered Export-Oriented Industrialization Strategy

## Chapter 1. Introduction

China has managed an average growth rate of 10% since it began economic reform and openness in 1978. It adopted a reform paradigm that depends on export to boost growth. In free markets where the movement of labor is unrestricted and wages are determined competitively, we would expect migration to tend to equalize the returns to labor among rural areas and between rural and urban areas. In China, however, this did not occur. There is a very considerable difference between rural and urban incomes. This is due to the Chinese urban-centered development policy, which can be characterized as "urban bias" (Lipton, 1977). Incomes in urban areas are higher. Public spending are disproportionately allocated to improve urban infrastructure and services. Moreover, it is argued that urban residents possess disproportionate political power and influence that further biased government policies aiding to their interest. Therefore, there is a continuing increase of urban-rural income gap. Where an urban-rural income gap exists and cannot be closed, it acts as a magnet to attract migrants from rural areas. Thus China was able to capture the gains of its comparative advantage in abundant labor supply. Cheap labor price became the principal attraction of FDI which further aided to export-oriented industrialization. And the accession to the WTO in 2001 has allowed

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China to play this advantage to the full.

Agricultural productions is no longer funding the national economic growth and hence no longer the focus of policy. On top of diminishing rural investment, the government, by keeping the price of agriculture products low, took a fraction of rural income to fuel the urban industrialization (Lu & Zhu, 2015).

China's adoption of export-oriented growth depends explicitly on wage competitiveness. This cannot be fully explained by its controlled exchange rate policies and even huge surplus of rural labor. It is a consequence of the government's fiscal, financial, and agricultural policies that biased against the rural area and transferred financial and human resources from its rural-agricultural sector to the urban-industrial sector (Lim, 2014).

Then what will be most likely development outcome if China continues to carry on its urban centered, export-oriented industrialization strategy?

While sustaining high growth rates, the export-led growth has also brought serious structural imbalances to China. The most noticeable one is the sharply declined share of wage, especially the low share of rural wage that created a sharp decline of domestic consumption power. The export oriented industrialization is highly relied on the global market's unsustainable demand and financing patterns. If there are crises like the 2008 world economy crash and the accompanying Great Recession, a global demand shortness will be an overarching structural condition. For a developing country like China, whose rapid export growth was cut abruptly since its high dependency on consumer demand in the developed countries, mainly the United States, it rendered the Chinese economy to confront a

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troubling outlook of significant demand shortage (Palley T. I., 2011). Yet it is impossible to direct these products surplus to the domestic market due to the low domestic demand and consumer purchase power.

The low level of consumption is due to the growing rural-urban income inequalities that exclude the majority of population from the benefits of rapid growth (Cao & Zhang, 2015). Further, a large part of the Chinese fiscal stimulus has been directed at creating infrastructure capacities that further aid to export instead of pushing up household consumption or improve domestic welfare.

During the process of China's high-speed urban centered export-oriented industrialization, rural peasants and migrant workers have borne the major costs. Peasants in China are already under great disadvantage from the outset because they possess a position at the bottom of the social hierarchy and having limited financial as well as social capital, Further they are mainly characterized as unskilled, undertrained and labelled as underclass in the city. This made them staying in the labor-intensive, low-paid jobs. It is hard for them to break through the invisible wall to establish real social networks with the urbanites as well as elevate their social status upward.

China is at a turning point of its 40 years of reform and economic opening. The global financial crisis exposed its vulnerability of dependency on global markets and export. Domestically, it is also facing with many structural problems that mainly attributed to the adoption of urban centered export-oriented policy. Continuing this pattern is certainly unsustainable.

China's urban centered, export-oriented industrialization strategy has created structural problems that have to be addressed for more balanced growth. The most significant problems include slow

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growth of residential income and domestic consumption, and heavy reliance on global market investment. Government should gradually cut the economy's dependence on export demand of the international market by focusing on boosting domestic consumption power through adjusting the current income distribution pattern to benefit the poorer and disadvantaged. This indicates the necessity to facilitate a new paradigm of domestic demand-led growth that characterized by focusing on building a healthier rural economic environment for the rural residence. Government and private reinvestment should focus on rural development while avoiding over investment on the export sector. Export sector should upgrade its structure and move up the value-added chain to maintain its competitiveness in the international market thus allow wage of labor to raise. Strong social safety nets also need to be the focus of policy and paid by better tax collection from those who can afford it.

## Chapter 2. Literature Review: China's Urban Centered Export-oriented Growth

### 2.1. Reform background

#### 2.1.1. Pre-reform era: The failure to adopt the Soviet model

The People's Republic of China was established in October 1949. China's economy was greatly interrupted by an eight-year battle against Japanese invaders as well as four years civil war between the Communist and Kuomintang forces. Its growth potential was devastated by the war and inflation. The leadership under Mao Zedong, Zhou Enlai, and other revolutionary veterans prepared the ground for China to embark on an intensive program of industrial growth and socialization. The new regime adopted the Soviet experience and went on to create an economic system largely modeled after it.

The Chinese system was based on extensive state ownership in the modern sector, large collective units in agriculture, centralized economic planning, central control over prices, and material balance plans that issued specific directives governing the allocation of major inputs, products, and financial flows. This period, which was officially designated the "transition to socialism" corresponded to China's First Five-Year Plan (1953-57).

##### 2.1.1.1. 1953-1957: *The Transition to Socialism*

#### Extensive State Ownership

Initially, after the Communist party had taken charge and the country proclaimed its

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independence in 1949, the Soviet Union became its closest ally. Soviet design, equipment, experts and skilled labor were set out to help industrialize and modernize the PRC. They worked to help establish new institutions that organized around annual and five-year plans. China began adopting the Soviet socialist system with a centrally planned economy. The leaders assumed this would help China from the aftermath of World War II and the civil war, and make it a rich and strong country.

As in the USSR, the key plan objective was to raise domestic savings, particularly by extracting resources from the rural sector, and to channel these funds toward industrial growth, particularly concentrating on heavy industry and capital-intensive technology. Soviet planners helped their Chinese counterparts formulate the plan. Large numbers of Soviet engineers, technicians, and scientists assisted in developing and installing new heavy industrial facilities, including many entire plants and pieces of equipment purchased from the Soviet Union (Federal Research Division, 2012a).

Government control over industry was increased during this period by applying financial pressures and inducements to convince owners of private, modern firms to sell them to the state or convert them into joint public-private enterprises under state control. By 1956 approximately 67.5 percent of all modern industrial enterprises were state owned and 32.5 percent were under joint public-private ownership. No privately owned firms remained. During the same period, the handicraft industries were organized into cooperatives, which accounted for 91.7 percent of all handicraft workers by 1956 (Mongabay, 1987a).

#### Large Collective in Agriculture

In the early 1950s, China had many pressing needs. They were, for example, food for a growing

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population, domestic capital for investment, and the purchase of Soviet-supplied technology, capital equipment, and military hardware. To satisfy these needs, the government began to collectivize agriculture (Federal Research Division, 2012a).

The ideology behind collecting agriculture is to improve efficiency of farming and increase government access to agricultural products. From the loosely structured, tiny mutual aid teams, villages were to advance first to the lower-stage Agricultural Producers' Cooperatives, in which families still received some income on the basis of the amount of land they contributed, and eventually to Advanced Cooperatives, or collectives. In the Advanced Producers' Cooperatives, income shares were based only on the amount of labor contributed. In addition, each family was allowed to retain a small piece of land on which to grow vegetables, fruit, and livestock for their own use. The collectivization process began slowly but accelerated in 1955 and 1956. Preliminary collectivization was 90 percent completed by the end of 1956. In 1957, about 93.5 percent of all farm households had joined Advanced Producers' Cooperatives (Dang, 2009) (Federal Research Division, 2012a).

In order to further break off the boundaries of existing communities, the scope of Producers' Cooperatives was expanded. Until the end of 1958, around 740,000 Producers' Cooperatives were reorganized into more than 20,000 People's Communes. People's Communes were created by combining some 20 or 30 advanced Producers' Cooperatives of 20,000 to 30,000 members on average, although membership varied from as few as 6,000 to over 40,000 in some cases (Dang, 2009). Everything was shared in the commune. Private kitchens became redundant and were replaced by communal dining. Everything in the private kitchen, such as tables, chairs, cooking utensils and pans

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all contributed to the commune's kitchen. All commune members could eat for free there. Everything originally owned by the households, such as private animals, stored grains and other food items were also contributed to the commune. They were put to different uses as assigned by the commune. All farming activities were to be centrally assigned by cadres every morning. Everybody in the commune was assigned jobs and tasks by their commune leaders (Federal Research Division, 2012a).

During the transition to socialism, China's another important measurement sought to central control of food prices, which was called "centralized purchase and sale" (Dang, 2009), especially on grain. As its name suggested, there are only unity purchase and sales of food national wide. The State established a national monopoly of food circulation by organizing the food supply and demand channel. This "centralized purchase and sale" system later developed into including food, oil, cotton and other agricultural products.

#### Centralized Economic Planning

A massive socialist industrial complex was set forth through direct government control. The economy and nearly every aspect of social functioning operated "according to plans" (Brown, 2012) (Mongabay, 1987a) (Naughton, 2007). Market mechanisms do not apply. Assigned production targets were issued to firms and famers. Resources and goods are directly allocated among different producers. Prices lost their meanings and could not signal directions of resource allocation in the economy any more. Finances were used to audit and monitor performance rather than drive investment decisions. While there were little market for farm products, there was no market for grain (Naughton, 2007). There was almost no market-driven labor mobility. Migration and urbanization halted.

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People's incentive to produce and work was low due to the nation's "centralized purchase and sale" on major agriculture products.<sup>1</sup> Communes exercised management and control over all rural resources such as labor and land. Everyone was allocated an equal amount of salary, supplies, food etc. every month, regardless of how hard they had been working.

In order to satisfy the overambitious Chinese industrialization strategy, prices, especially the prices of agriculture products, were kept artificially low. Taking grain production for example, farmers could only sell grains to the commune at a set price and keep only a rationed amount of grain to satisfy household needs. Private storage of agriculture products was not allowed. A fraction of rural income was thus expropriated in support of developing heavy industry. The government directed resources to capital-intensive factories producing metals, machinery and chemicals, but neglected labor-intensive sectors suitable to China's vast population. Because industrial investment was not only capital-intensive but also technologically demanding, the economic return was often low, in the sense that capital was tied up for a comparatively long period of time without producing output (Mongabay, 1987a) (Naughton, 2007).

Demand increased to the point where supply could not keep up, leading to shortages in the price-controlled products. This was one of the main reasons why China's agricultural development stagnated, coursing a serious shortage of agricultural products. Amplified by the bad weather in 1958, 1959 and 1960, famine became widespread.

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<sup>1</sup> Though started with agriculture products' price control, this control later moved on to products relate to almost all aspects of life. For e.g. cloth, metal ware etc. (Federal Research Division, 2012a).

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### *2.1.1.2. 1958-1976: Great Leap Forward and Cultural Revolution*

Judging from the fast formation of collectivism during the First Five-Year Plan, people anticipate of that “communism would soon be realized”. The leadership was eager to “really show [the world] the superiority of socialism with higher initiatives and labor productivity” and “have great confidence on transforming [China] from socialism to communism in 10 years” (Dang, 2009).<sup>2</sup> The leadership adopted an approach that relied on spontaneous heroic efforts of the entire population to produce a dramatic “great leap” in production for all sectors of the economy at once (Federal Research Division, 2012b). This was another representation of the government’s great eagerness to reach fast economic success.

In order to “leap” to a higher stage of productivity, the agriculture sector underwent some further reorganization. Moreover, surplus rural labor also was to be employed to support the industrial sector by setting up thousands of small-scale, low-technology, “backyard” industrial projects in farm units, which would produce machinery required for agricultural development and components for urban industries (Federal Research Division, 2012b).

People’s Communes reached their peak during that era. The communes acquired all ownership rights over the productive assets of their subordinate units and took over most of the planning and decision making for farm activities. It is believed, ideally, that communes were to improve efficiency of productivity by moving farm families into dormitories, feeding them in communal kitchens and

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<sup>2</sup> According to the Marxist’s Theory of Productive Forces (sometimes referred to as Productive Force Determinism), technology and productivity advancement should be given primary emphasis in order to achieve real socialism and eventually communism. Thus it is not difficult to see the reason of Chinese leadership’s eagerness on improving productivity (Government of China, 2013).

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moving whole teams of laborers from task to task (Federal Research Division, 2012b). In practice, this ideal was never carried out. This is because that everyone is less incentive to produce more since they receive equal payment regardless whether they work hard or not. Further, leaders of communes tend to boast unrealistic production goals in favor of their own political future or promotion. For example, in a Chinese commune, a paddy field of one Chinese acreage<sup>3</sup> can normally yield approximately 800 pounds per harvest season; and a High-yield experimental test field of paddy can produce around 2000 pounds per Chinese acreage (Lu H. , 1990). In order to compete, standards of yield were set higher and higher between communes. Some said they could produce 10,000 pounds per Chinese acreage, some said 20,000 pounds, until some claimed a production of 50,000 pounds! In order to achieve these overstated goals, an incredible amount of fertilizers were poured into the fields in hope of faster and greater production, which never happened. Seedling was too dense, and many crops rotted because of a lack of air and high temperature. Another example, commune members were also motivated to “[produce] eight million pounds of steel in three weeks...to fly our ‘satellite’ in no time...” (Lu H. , 1990). However, after three weeks, only a couple of pounds sintered steel had been made from pot and pans.

The Great Leap Forward ended badly and had caused many serious economic consequences such like shortages of food and raw materials for industry, overproduction of poor-quality goods, deterioration of industrial plants through mismanagement, and exhaustion of the peasantry and of the intellectuals, etc. Agriculture became hardly sustainable from the resource and work forces drain (Federal Research Division, 2012b). This was another reason, other than “central control over price”,

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<sup>3</sup> One acreage approximately equals to 6.07 Chinese acreage.

that leads to the China's great famine from 1958 to 1961.

On top of false directions on development strategies, political struggles within the Communist Party also contributed greatly to China's economic stagnation and even recession. Mao was criticized in the party conferences for the failure of the Great Leap Forward. He resigned from the position of State Chairman in 1959, although he did retain his position as Chairman of the Communist Party. Liu Shaoqi became the new PRC Chairman and reformist Deng Xiaoping became CCP General Secretary. They assumed power of policy making and decided to bring the economy back to recovery. Obviously the communes were not only unable to successfully carry out all the managerial and administrative functions that were assigned to them, but also failed to effectively raise productivity. In order to address the problem of lack of material incentives to the production brigades and teams under the communes' organization, efforts were focused on modify the administration of the communes in 1959 (Federal Research Division, 2012b).

Yet these efforts were cut abruptly by the Great Proletarian Cultural Revolution, or simply the Cultural Revolution, which was set in motion by Mao in 1966 and lasted until his death in 1976. It was an attempt of Mao to regain political power and reestablish authority within the party and country. He believed that the party and the country in general need to be "purified" from the creeping "capitalist" and antisocialist tendencies (Mongabay, 1987b). He felt that the material incentives that had been restored to the peasants and others were corrupting in nature and counterrevolutionary (Federal Research Division, 2012c). He then brought up the point that efforts should be made to create a classless society: no-one was better than anyone else and all working for the good of China.

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The main theme of the movement was the restoration of revolutionary fervor amongst party members and the general public. Pupils in schools and colleges were urged to return to the basic principles of the revolutionary movement. Chinese youths were also encouraged to openly criticize the liberals in the Chinese Communist Party.<sup>4</sup> Mao believed that the progress China had made since 1949 had led to a privileged class developing such as engineers, scientists, factory managers etc. Mao also believed that these people were acquiring too much power and had a potential tendency of “following the capitalism path”. (Mongabay, 1987b)

Red Guards (groups of youths who banded themselves together) encouraged all the youth in China to criticize those who were “untrustworthy with regards to the direction of China’s development” (Mongabay, 1987b). No one was safe from criticism especially those who were categorized as the privileged class. Anyone who dared to make comments against these criticisms were deemed counterrevolutionary thus considered an enemy of the party and the people and were either put out of job or under public condemn. The revolutionary enthusiasm set off by the Cultural Revolution pushed China into social turmoil. The modern sector of the economy was affected the most, and cities suffered more upheaval than the rural areas. Production was greatly interrupted because the political activities of workers in the mines and factories. Output at many factories suffered from shortages of raw materials and other supplies. Another cause of production shortage was that the management power of factories were placed in the hands of the Revolutionary Committees whose member

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<sup>4</sup> Two major representatives of liberals in the CCP was Liu Shaoqi (the new PRC Chairman) and Deng Xiaoping (CCP General Secretary); who, the former one end up been expelled from CCP and the later one was put out of power until the end of the culture revolution.

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consisted of representatives from the CCP, the workers, and the People's Liberation Army. The committee members usually had little knowledge of management. In addition, nearly all engineers, managers, scientists, technicians, and other professional personnel were criticized for not being politically corrected thus were sent to the countryside to "participate in labor (for personal reform)", or even jailed, all of which resulted in their skills and knowledge being lost to the enterprise. The effect was a 14 percent decline in industrial production in 1967, and another 5 percent decline in 1968 (Mongabay, 1987b). Schools and colleges were closed and groups of Red Guards fought other groups of Red Guards as each separate unit believed that it knew best how China should proceed. In some areas the activities of the Red Guards got out of hand. They turned their anger on foreigners and foreign embassies got attacked. For example, there is the incident that British Embassy was burned down completely (Federal Research Division, 2012c).

Comparing to the Great Leap Forward, the Cultural Revolution was mainly a political upheaval and did not have major changes in official economic policies or the basic economic model. Even so, from the previous description, it is not hard to see the Cultural Revolution had a far-reaching influence throughout the society and economy.

## **2.1.2. China in reform**

### *2.1.2.1. Facing problems*

By the 1970s China had reached an economic stage that was almost unable to sustain any longer. The Chinese model of self-reliance and communism, once was hold by both the Chinese and many from abroad as a superior model of development for the Third World, offered diminishing returns to

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the Chinese people. A high psychological price had been paid by the self-destructive isolation during the Cultural Revolution. It also offered diminishing incentives for the Chinese population to work harder indefinitely for the sake of far-off rewards (Gittings, 2005).

By the end of 1970s, China's economy suffered from many drawbacks that some inevitably for a planned socialist economy and some uniquely Chinese. For example, incomes rose much slower than GDP, hardly at all in the rural areas. National incomes were used for investment in continuing industrialization rather than passed back to its people to stimulate consumption (Gittings, 2005). The agriculture sector and peasants, although claimed to receive priority by policy, continued to suffer from no investments input. On the contrary, incomes in urban areas were twice as high as those in the countryside which made inequalities between rich and poor areas persisted. The hard control over culture and public opinions by the Party also discouraged innovation and experiment (Gittings, 2005).

#### *2.1.2.2. 1978: Reform and opening*

The unsuccessful attempts in order to achieve socialism and the disastrous Great Leap Forward and the Cultural Revolution led to doubts about socialism as a development strategy and to the growing belief that the market could be a superior instrument of development.

Deng Xiaoping regained power and announced the start of political, economic, social, and cultural reforms at the Third Plenary Session of the Eleventh National Party Congress Central Committee in December 1978. This session is considered a major turning point in modern Chinese political and economic history. Deng Xiaoping (1993) pointed out that "The essence of socialism is the liberalization and development of productive forces, the elimination of exploitation and polarization

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between rich and poor, and the eventually a common prosperity for all.” Thus, economic development was set as the top priority.

The Four Modernizations<sup>5</sup> officially replaced the classic party line calling for prolonged class struggle. Economics, instead of politics, became top priority in future development. Thus success or failure of policies and individual leadership will be measured by the realization of economic goals. The central policies of the reform program were introduced during the Third Plenary Session. The strategy slogan was “Internally reform; externally open up”.<sup>6</sup> Deng Xiaoping suggested that practical measures should be taken step by step to realize economic recovery and strengthening. The reform program essentially stressed economic self-reliance and called for an expansion of the research and education system and for exchanges of students and “foreign experts” from developed countries. Foreign trade was to be increased by opening up markets, especially the purchase of machinery from Japan and the West. By participating in such export-oriented growth, it was believed that China would be able to speed up its economic development through foreign investment, a more open market, access to advanced technologies, and management experience.

The plenary session also discussed agricultural issues. Agriculture was the foundation of the national economy in needed of great policy attention. In order to improve the living standards of people across the country, it was important to accelerate the development of agricultural production. The plenary session presented a series of policy measures regarding the current development of

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<sup>5</sup> The Four Modernizations were in the fields of: Agriculture, Industry, National Defense, and Science and Technology. The Four Modernizations were designed to make China a great economic power by the early 21st century.

<sup>6</sup> As in Chinese written: 对内改革,对外开放. (Deng, 1993)

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agriculture and peasantry. New agricultural policies, which intended to loosen political restrictions on peasants and allow them to produce more on their own initiative, were approved (Government of China, 2013). By 1989, agriculture has been effectively privatized and the profit motive became accepted as the dominant force throughout the economy.

### **2.1.3. Why “let some people get rich first”: The validity of urban centered export-led industrialization strategy in China and the theoretical support for the Chinese reform**

China started the economic reform as early as the late 1970s and early 1980s. It began with the coming of foreign businesses and governments. China needed capital, technology, manufacturing expertise, management knowhow, and overseas markets for its products. It also needed to generate sufficient surplus value to finance the modernization of the Chinese economy. The policy at that time mainly consisted of opening trade to the outside world, attracting foreign investment, instituting the contract responsibilities system in agriculture, by which farmers could sell their surplus crops and place them on the market.

Production possibilities and costs were again determined by markets hence the price system was reinstated. Government reduced its intervention in the market. An “open door” (Deng, 1993) policy was introduced by which China began to allow international trade and foreign direct investment. Relatively, China, along with its immense labor and huge market, set forth to play a key role in global competition. These initiatives immediately increased the standard of living for most of the Chinese population and generated support for further reforms.

By the end of the 1980s China had almost solved its food shortage problems. Aiming at creating

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market institutions and converting the economy from an administratively driven command economy to a price driven market economy, economic reforms that time mainly focused on boosting export-oriented industries. Around the 1990, six special economic zones along the coast (SEZs) were established, for example, the famous Shanghai Pudong zone, which was a pioneer at attracting foreign capital. These zones played a crucial role in Chinese economy and made China a huge sweatshop for the West's cheap goods and gave it an average annual growth of 10% (Mishra, 2006).

The character of Chinese export-oriented industrialization strategy was both urban centered, "zone" centered. State secretary Deng Xiaoping's phrase "Let some people get rich first" (Deng, 1993) well described this reform intention. Urban incomes were raised and protected and urban infrastructure and services receive priority over rural. Resources and investments were first directed to urban areas to facilitate export. Where an urban-rural income difference existed and unable to close, it acted as a magnet to migrants from the rural areas. Abundant labor supply drove down labor cost and became China's main comparative advantage in global competition. Further, cheap labor price also attracted a significant amount of FDI which focused on export-oriented industries. Eventually, in 2001, China's accession to the WTO marked the complete integration of China into the world market and further aided the deepening of its export-oriented industrialization.

As for why the "Let some people get rich first" strategy and why rural China willingly takes some loss in order to support this strategy, a couple of welfare economics theories nicely explain the rationale behind it.

### *2.1.3.1. Some helpful welfare economics theories*

Generally speaking, welfare economics is a branch of economics that uses microeconomic techniques to evaluate economic well-being and social welfare in terms of economic activities of the individuals that comprise the theoretical society considered. Individuals, with associated economic activities, are the basic units for aggregating to social welfare, whether of a group, a community, or a society, and there is no “social welfare” apart from the “welfare” associated with its individual units (Weston & Townsend, 2011).

Since welfare economics is a methodological approach on evaluation of policies, some basic concepts of it should be introduced in order to help on evaluating China’s reform policies. There are generally two theories presented: first, the Kaldor-Hicks efficiency, which helps on understanding the question of how to decide a reform should or should not be implemented and second, the North-Davis standard, which helps to decide who will support the reform and why.

Even though welfare economics employs many criteria which are usually quantitative, they are of less concern for this paper. The focus is, by the help of some basic welfare concepts, to have a better understanding of the ideologies behind a reform, and, what matters when implementing and advancing a reform.

#### Kaldor-Hicks Efficiency: why let some people get rich first?

How to decide whether or not to implement a new policy or reform? The answer is to do a cost-benefit analysis to make a decision that brings improvement. Many of us would immediately think of the Pareto Efficiency theory which is usually referred to as the Pareto Optimal. An outcome is said to

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be Pareto Optimal, if every benefits and no one is better off at somebody else's cost. However, this criterion for efficiency is thought to impose a very strict standard, since there are very few transactions in the real world that will fit into it. Most exchanges or transactions involve external costs, which on most occasions impose substantial costs on society. By discussing the case of repealing the "Corn Law" in England, Kaldor (1939), in his article *Welfare Propositions and Interpersonal Comparisons of Utility*, proposed to make some modifications to the Pareto Efficiency:

In all cases, where a certain policy leads to an increase in physical productivity, and thus of aggregate real income, the economist's case for the policy is quite unaffected by the question of the comparability of individual satisfactions; since in all such cases it is possible to make everybody better off than before, or at any rate to make some people better off without making anybody worse off ..... There is no need for the economist to prove --- as indeed he never could prove ---that as a result of the adoption of a certain measure nobody in the community is going to suffer. In order to establish his case, it is quite sufficient for him to show that even if all those who suffer as a result are fully compensated for their loss, the rest of the community will still be better off than before. (p.33)

This book's publication represented the formation of the new welfare economics in the western world whose theoretical origins could be traced back to Pareto's theory. In the late 19th century and the beginning of the 20th century, Pareto, Edgeworth, Fisher, and some other scholars proposed a new micro-analytical tool: Indifference Curve Analysis Method. Based on this method (Samuelson, 1947, ed. 1983), they established the Ordinal Marginal Effect Theory which states that the effectiveness of commodity can only be compared ordinally, but not be measured cardinally in terms of absolute price. Pareto analysed the use of these new tools and new value theories, and proposed a new standard to maximize the socio-economic welfare which is called the Pareto Optimization Principle.

New welfare economists generally share the same point of view that personal well-being cannot be measured using cardinal numbers but only be compared in ordinal order (Samuelson, 1947, ed. 1983). But they share some disagreements to the Pareto Optimum Principle. The new welfare economics was later divided into two schools of thoughts: one is the school of "Compensation Principle" headed by Kaldor, Hicks and Scitovsky; the other is the school of "Social Welfare Function", led by Bergson, Samuelson, which focused on the examination of fundamental social welfare standards and add some further supplemented (Samuelson, 1947, ed. 1983). The next couple of chapters will be a discussion on both schools.

The school of "Compensation Principle" extended the criteria of Pareto Efficiency on measuring policy implementation. According to the Pareto Efficiency, an outcome is more efficient if at least one person is made better off and nobody is made worse off. It seems to be a reasonable way to determine whether or not an outcome improves economic efficiency. However, some believe that in practice, it is almost impossible to take any social action, such as a change in economic policy, without making at least one person worse off. Even voluntary exchanges may not be Pareto improving. Under ideal conditions, voluntary exchanges are considered to be beneficial to both parties since, unless mutually beneficial, individuals would not enter into such exchanges. However, a voluntary exchange does not meet the criteria of Pareto Efficiency when external costs (such as pollution that hurts a third party) exist, as they often do. With this respect, Kaldor proposed a new criteria which relaxed certain conditions of the original one.

Kaldor believe a change that resulted in either a "Pareto improvement" or in "winners" from the

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change compensating the “losers” to be acceptable. This is called The Kaldor Criterion. An outcome is considered more efficient if a Pareto optimal outcome can be reached by arranging some compensation from those that are made better off to those that are made worse off. In one word, if a plan could yield a benefit higher than its cost, it is a profitable plan (Kaldor, 1939).

Hicks made some further adjustments to Kaldor Criterion. He think, when the “losers” could not afford to bribe the “winners” to prevent the change, then the change would also happen. This is called The Hicks Criterion. That is, the plan is implementable (Hicks, 1939). Hicks further brought in the analysis on uncertainty. He believes that as long as each measure of social and economic changes is able to improve efficiency and productivity, national income will be increased. After a sufficiently long time, the welfare of all members of society will improve, but the improvement speed will differ. Some fast, some slow, some go first, and some come later. But in the end, the losers will eventually get compensation.

These two criteria became known as the “Kaldor-Hicks Criterion”, also referred to as “Kaldor-Hicks Efficiency”. This measure of economic efficiency captures some of the intuitive appeal of the Pareto Efficiency, but has less stringent criteria and is hence applicable to more circumstances. Using the Kaldor-Hicks Efficiency, an outcome is more efficient if those that are made better off could in theory compensate those that are made worse off, so that a Pareto improvement results. For example, a voluntary exchange that creates pollution would be a Kaldor-Hicks improvement if the buyers and sellers are still willing to carry out the transaction even if they have to fully compensate the victims of pollution.

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The key difference between the Pareto Efficiency and Kaldor-Hicks Efficiency is the question of compensation. Kaldor-Hicks does not actually require compensation to be paid, merely that the possibility for compensation exists, and thus does not necessarily make each party better off (or neutral). Thus, under the Kaldor-Hicks Efficiency, a more efficient outcome can in fact leave some people worse off. While every Pareto improvement is a Kaldor-Hicks improvement, most Kaldor-Hicks improvements are not Pareto improvements. This reflects the greater flexibility and applicability of the Kaldor-Hicks criteria relative to the Pareto criteria.

Crucially, the compensation or bribe elements in a Kaldor-Hicks improvement are hypothetical: the change is considered an improvement if the assessed winners' gain is greater than the assessed losers' loss, regardless of whether the change when implemented would actually involve the payment of any compensation. It is this aspect of Kaldor-Hicks Criterion that has triggered the most debate and earned significant criticism. For example, Ian Little (Jing, 2002) mentioned that the Kaldor-Hicks Criterion considers only economic efficiency rather than treat "efficiency" and "equity" equally. Regarding Hicks's hypothetical compensation argument, Little said: "If a long time is a long time, then most of the people will not live [long enough to benefit from Pareto improvements] (Jing, 2002)."

Bergson also agreed that the issue of income distribution should be taken into consideration. He thinks it is inappropriate that the Kaldor-Hicks Criterion puts efficiency over fairness. Following Bergson, Samuelson and some other scholars have further elaborated this argument and formed the thought of "social welfare function" (Samuelson, 1947, ed. 1983). They think that social welfare equals to the total sum of each individual's welfare. Thus social welfare can be affected by variables like the amount

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of commodities each social member purchased, each member's productivity, as well as other related elements. It could be written in a multivariable function:  $W = F(Z_1, Z_2, \dots)$ , where "W" stands for social welfare; " $Z_1, Z_2, \dots$ " stands for a variety of factors affect the social welfare. Further, in their point of view, social welfare and income distribution is closely related. That is because even if production and exchange reach their optima, social welfare optimum still cannot be achieved without reasonable/equal distribution of income (Jing, 2002).

In respect to the above mentioned some new welfare economics theories especially the Kaldor-Hick Criteria, let us revisit the phrase "let some people get rich first". Other than the beginning of the reform, China has been carrying out a reform that favors urban development over rural, and favors export over other industries. The thought was to boost economic growth to accumulate sufficient fund that later could be used to raise incomes for all. Yet the deficiency of this thought is a lack of proper policy or regulation on reasonable/equal distribution of incomes to ensure social welfare optimum to be actually reached. Nonetheless, China saw it is justified enough to carry out its urban centered export-oriented industrialization strategy.

The Kaldor-Hicks Criterion helped understand the rationale of why certain reform strategy is chosen. Whether or not a reform can fully be conducted depend on how many support it can get. Then, How social members decide to support a reform or not? Davis and North's research offers a way to assess this question.

#### North-Davis Standard: who will support a reform and why

Two institutional economists, Davis and North, conducted a study of the sources of institutional

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changes in American history. Using their own word, the goal of the authors was hoping this “intellectual journey through American economic history [is] . . . to provide a description of the processes that have produced the present structure of economic institutions.” They finally lay out a model where “the core logic of institutional change is neoclassical cost-benefit analysis and the motivating drive for institutional change is profit maximization (Davis & North, 1971).” They assume that intuitions and social members devote all effort towards profit maximization. Institutions analyze cost and benefit to determine whether new institutional arrangements should be carried out in order to yield better total outcomes (i.e. improvement of income, efficiency, or reduction of cost, externality etc.); individuals analyze cost and benefit to decide whether they should enter into any new agreement or take up any new action. That is to say, a new arrangement could only gain support if its expected benefit outweigh expected cost, or at least break even, for its supporter.

Once decided to participate/support in a new arrangement, social members respond to the time and risk of expected returns differently due to their differences in education, cultural, and occupation etc. For example, a comparison of the different investment expectations of a banker and a farmer. The farmer, who sows seeds every spring and harvest every autumn, would like to see returns be sooner and secure. The farmer will likely to prefer a lower risk with fast return type of investment. He probably do not mind a small return as long as there is some return guaranteed. On the contrary, a banker would more likely prefer a large return for his investments. Supposedly, associated with this kind of investment, there will be higher risk and probably longer wait. Davis and North (1971) used the term “discount rate” to differentiate people with different investment expectations in regard of time, risk,

and amount. The farmer have a higher discount rate compare to the banker.

In the bank system, discount rate means an interest rate that central bank charges when depository institutions borrow reserves from it. The interest rate is positive, because interest need to be paid to borrow money. In modern economics, discount rate gradually evolve into an important basic concept. With further taking “time” into consideration, it helps with evaluating a future economic activity. This “time” means comparing values of return between shorter or longer period. A dollar in the future, whether it is an income or loss, is not the same value as a dollar at present. Since during the period of present and future, many uncertainties might happen such as inflations, social changes etc. That makes the future value of today’s one dollar to be uncertain. The longer the time, the more uncertainty. What will happen in the future, win or lose, is not as important as what is winning or losing at present. To what degree it matters or matters not, is the “discount rate”. Back to the example of farmer and banker. The farmer wants his effort to be paid off soon so he could use the income to purchase next year’s seed and equipment. A fast and steady money circulation matters more to the farmer than the banker who, has much more spare capital on his dispose. Hence, in the long run, the expected return is “discounted” more for the farmer thus a higher discount rate for the farmer.

A dollar in the future do not equal the value of a dollar at present. And the longer this present-future interval, the higher discount rate which means the lower this dollar values in the future. Thus while making investment decisions, only calculating absolute value of returns is far from enough. For example, a statement such like, this 1 million dollars investment will bring a total return of 2 million dollars, does not at all justify the investment. If the collection of 2 million dollars return will have to

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wait until, say, 50 years later, countless factors could influence the outcome to make the original investment unsuccessful. Further, there are also the opportunity cost of the investment that may be made elsewhere. For example, there is another option to deposit the 1 million dollars in bank at an interest rate of 3%. 50 years of interest earning will be 3.38 million. Comparing the returns, the original investment was not worthwhile making. The opportunity cost for capital investment is gains from saving them in bank. And the opportunity cost for work/labor investment is the value of products that could otherwise be produced. In an extreme case, where the banker does not matter at all for any risk and is willingly to wait as long as it takes for his desired return, the discount rate will be zero and there will be no opportunity cost.<sup>7</sup>

The concept of discount rate in investment later was introduced in to a social scenario by some sociology scholars (Gruber, 2004), at where it is called social discount rate. With more social parameters bring into account, the basic idea is nonetheless the same. A higher social discount rate means people have low expectations toward future returns. For example, a nuclear power plant with a life span of 30 years. Although it involves a huge cost to clean up the site and disposal of nuclear waste at the end of its life span, because it is 30 years later, the estimated cost in the future, after “discounted” to fit into the current value, is considered acceptable.

A high social discount rate is a signal of people losing confidence for the future. People thus are unwilling to take responsibilities and society suffers from deterioration of morality and lack of

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<sup>7</sup> For further analysis, please refer to Gruber (2004). “Chapter 8: Cost-Benefit Analysis” Public Finance and Public Policy, pp. 201-223. London: Worth Publishers.

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credibility. Weak social or government function also lead to a high social discount rate since people are losing faith and have little positive expectation for what is to come next.

The basic concept of discount rate is very useful in evaluating all kind of project implementation. Many social scientists have made efforts in identifying factors that determine the social discount rate. Possible factors including political and social stability, mortality rate, and average life expectancy, economic discount rate etc. (Gruber, 2004). Some scholars even have tried to estimate the value of the social discount rate.<sup>8</sup>

So far, with all the terms used here: discount rate, opportunity cost, etc. It is not important to get into detail of how to calculate or quantify them, rather, they all serve the purpose of explaining who will support a reform and why. Now to summarize as below:

1. The basic North-Davis standard: the members of a society evaluate a change of policy (or a new reform) base on the distribution of returns. Individuals evaluate their personal cost and benefit during involvement to decide if they will vote for or against a reform.

2. The extension of North-Davis standard: the outcome of a reform is decided within a dynamic social level where almost countless variables exert their influences (variables such as social economic conditions, residents' life expectancies, literacies, environment conditions, resources, etc.).

3. The concept of discount rate: what will/might happen in the future is of less importance compare to current happening, and the importance keeps decreasing over time. Discount rate is a term

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<sup>8</sup> For more information, please refer to: Yuan, Liangqing. (2005). 社会贴现率的确定 Ascertain of social discount rate. Special zone Economy. 2005(07).

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used to exam the speed of this decrease. The higher the rate, the faster the rate of decrease. Use again the farmer and banker's example. A higher discount rate of the farmer than the banker means the farmer values a faster collection of investment returns since these returns will be "discounted" faster for him over time. Differences of the farmer and banker's occupation and perhaps also their different educational and financial background decided their different investment needs and expectations.

Any reform is a long and complex procedure that involves lots of uncertainties. Members from different social stratification react differently toward the same policies. Their expectations of collecting returns would also not fall into a same period. The general conclusion is: low-income social groups tend to have a higher social discount rate which means they are more inclined to receive returns faster hence tend to choose an arrangement that could yield returns accordingly. The high-income social groups, on the other hand, have lower social discount rate which means they concern more for an investment's mid to long-term benefit thus they have expectations for higher returns over a longer period compare to the low-income groups.<sup>9</sup>

In the real world, it is very likely a reform that suits the Kaldor-Hicks Efficiency, which enables productivity improvement and wealth accumulation, may not at the meantime be satisfactory to all. This is because it is almost impossible to fulfill every social member's "Davis-North Standard" to make them all enjoy a net income increase from the reform at once. Some social members' gains is accompanied with some social members' loss thus created a certain level of inequality. Whether or not this reform can still be implemented will then depend on the game results between the social

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<sup>9</sup> For further in-depth researches, see Hicks (1939).

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members who pro- or oppose it.

In perfect democracy, the Majority Rule decides whether or not to pass a reform for implementation. A reform which conforms to the “Kaldor-Hicks Efficiency” might still be boycotted by the majority for not meeting their “Davis-North Standard”. This poses a point worth thinking: a program that may have a potential to greatly enhance productivity and social wealth may not be implemented because of the problem of benefit distribution --- the interest inconsistency of different interest groups (Gruber, 2004). To keep the majority social members satisfied is an important task that all leaderships face, under all circumstances, since people need to be constantly persuaded. For the government authority, the key to a reform’s advancement is not only realizing true enhancement of productivity and social wealth, but also establishing a solid and equal income/return distribution system so as to constantly keeping the majority’s interest and support.

#### *2.1.3.2. The validity of "letting some people get rich first" strategy*

China chooses an urban centered export-oriented industrialization strategy which is to generate funds for industrialization through export at the support of rural area and rural population. At the threshold of its economic reform, China well recognized possible inequality problems incurred. Deng Xiaoping’s famous statement “Let some people get rich first”<sup>10</sup> clearly indicated this. It is made clear that Deng was willing to adopt this, recall the Kaldor Criterion, “profitable” reform strategy. In believe that improvements in the general economy will benefit all participants in that economy eventually,

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<sup>10</sup> On October 23, 1985, while meeting with the U.S. business delegation, Deng Xiaoping for the first time said that: “[we] could allow some areas and some people get rich first to promote and help other areas, other people. And gradually achieve common prosperity (Naughton, 2007).” He also repeatedly mentioned this comment later in many other occasions.

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Deng's statement: "a rising tide lifts all boats (Deng, 1993)" made a conclusion on the result of reform and suggested a possible compensation / allocation plan for later.

While the Kaldor-Hicks Criterion helped understand the rationale behind China's reform strategy, the Davis-North Standard help to bring some insights on analysing how China could generate its support from the majority population for reform implementation. The economic reforms started since 1978 has helped lift millions of people out of poverty, bringing the poverty rate down from 53% of the population in 1981 to 8% by 2001 (World Bank, 2009). Government leadership believed that it is important to let workers and farmers to be re-initiated at producing more surplus and to tilt the economy back to balance. This idea suits the majority Chinese interest and every social group can benefit from it.

The main points of China's new economic development strategy include: management power decentralization on the state owned enterprise (SOE) sector, introduce market mechanisms to replace command allocation, abolish the commune system, restore material incentives in workplaces and encourage competition (Naughton, 2007). The start-up point is introducing market institutions to the rural areas. Policies mainly include downsize agriculture, eliminate prize control of agriculture products, and replace communes with the contract responsibilities system in agriculture, by which lands from People's Communes, though still owned collectively, can be cultivated privately. Farmers were able to keep the land's output after paying a share to the state (Sandwip Kumar & Monica, 2013). This reform of agriculture immediately brought a significant improvement in agriculture production, increased the living standards of millions of farmers. The bottom-up approach of the reforms promoted by Deng, in

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contrast to the top-down approach that China copied from the former Soviet Union, is considered an important factor contributing to the success of China's economic transition (Sandwip Kumar & Monica, 2013). As rural populations consists of the majority part of the total population<sup>11</sup>, it help gained enormous support for carrying out further reforms from the society bottom-up. Earlier doubts about the reform were also eliminated and everyone was convinced by the good results from agriculture reform and believed in a promising prosperity future that would carry out by deepening the reform.

The same methodology of in agriculture reform were also introduced in urban industry to increase productivity. Starting in 1979, a dual-price system was introduced, in which SOEs were allowed to sell any production above the plan quota allowing citizens to avoid the shortages of the Maoist era. Moreover, the adoption of industrial responsibility system in 1980 further promote the development of SOEs by allowing individuals or groups to manage the enterprise by contract (Sandwip Kumar & Monica, 2013). These reform measurements were no doubt successful. Chinese people were motivated and enthusiastic for further reform. Yet with the reform pushing forward, some of the consequences of China's urban centered export-oriented industrialization strategy also began to show.

Signs of imbalanced economic development started to show between rural and urban, whereas the rural and interior areas of China were far less developed. This is even a case that persists to today. Many factors can be the cause. For example, there are geographical challenges of some remote areas;

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<sup>11</sup> When the economic reform was initiated in 1978, the rural population was 790 million, account for 82% of the entire population. (National Bureau of Statistics of China, 2016) Economic reform lead to fast industrialization and urbanization of China. Even though the rural population decreased its share among the entire population, it still maintained a more than half (about 55%) percentage in 2015. (National Bureau of Statistics of China, 2016) There is no doubt that the rural votes means critical to any development policy's implementation in China.

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and there are different social, demographic and cultural structures of many interior areas often differ significantly from those of coastal China. What is more, comparing to urban, rural areas usually suffer more from infrastructure and information shortages. The above factors are all the natural districts that differentiate rural from urban. They do play certain parts on aiding to the rural-urban economic differences, yet this thesis argues that China's urban centered export-oriented industrialization strategy played a dominant role on aiding to the economic imbalance across rural and urban regions. The next section will be reviewing the discussions regarding the export-oriented industrialization strategy.

## **2.2. Export-Oriented Industrialization (EOI)**

China has managed an average growth rate of 10% since it began economic reforms and opening in 1978. The Chinese economy abandoned its old planed system by transforming into a market economy. This had resulted in significant productivity growth and boosted the Chinese economy in a remarkable way. China adopted an export-oriented industrialization strategy that has explicitly depended on export to boost growth. Joining the WTO in 2001 allowed China a whole integration into the world system to fully capitalize on its large labor supply to play this strategy into its fullest. Next this section will start with a brief introduction of the EOI strategy and move into reviewing related debates.

### **2.2.1. Origin of the Theory**

Export-oriented Industrialization (EOI), sometimes called export substitution industrialization, export-led industrialization or export-led growth, is a trade and economic policy aiming to speed up

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the industrialization process of a country by exporting goods for which the nation has a comparative advantage (Palley T. I., 2011). Its characteristics include government support of export sectors by reducing tariff barriers, devaluation of national currency and so on.

From the Great Depression to the years after World War II, under-developed and developing countries started to have economic difficulties. During this period, it was difficult for countries to resort growth or income earning need to export since many foreign markets were closed and not to mention the danger of trading and shipping in war-time waters. Regarding this situation, development strategies adopted by many under-developed and developing countries was called Import Substitution Industrialization (ISI) strategy. Both Latin American and Asian countries used this strategy at first. However, the apparent failure of the ISI strategy<sup>12</sup> consequently led to the strengthening of the case for the adoption of a more external looking industrialization strategy among these countries. Later many Asian countries, like China, Malaysia, Thailand, South Korea and Taiwan (province of China), started focusing their development outward, resulting in an export-led growth strategy (Palley T. I., 2011).

EOI is a development strategy aimed at growing a country's productive capacity by focusing on foreign markets. It started in the late 1960s and early 1970s with the emergence of a new international

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<sup>12</sup> The main critique about ISI strategy is that it requires government's provision of tariff and quota protections which lead to productive inefficiency and rent seeking. Many articles and case studies have provided in-depth discussion about the ISI strategy. See for example:

James, Dilmus D. (1982). "Structuralism, and Dependency in Latin America." *Journal of Economic Issues*, 16(3) p. 673-689.

Baer, Werner (1972), "Import Substitution and Industrialization in Latin America: Experiences and Interpretations", *Latin American Research Review* vol. 7 (Spring): 95-122.

division of labor and production structure where large corporations from advanced economies start to relocate production overseas to the less developed countries in search of cheaper labor. This was especially true of the electrical and electronics industries that assembled in less developed countries like China and the products shipped back to home countries that are usually the advanced economies like the US. Korea and Taiwan, because of their strategic relationship to the U.S. during the Cold War, benefitted from this process and were able to gain access to technology through licensing and franchise without heavy dependence on foreign direct investments (FDI) (Lim, 2014). Some have pointed out that the success of the Asian countries, especially Taiwan and South Korea, have justified benefits of economic openness and globalization. And export-oriented growth should be considered the best strategy to promote development (Gibson & Ward, 1992).

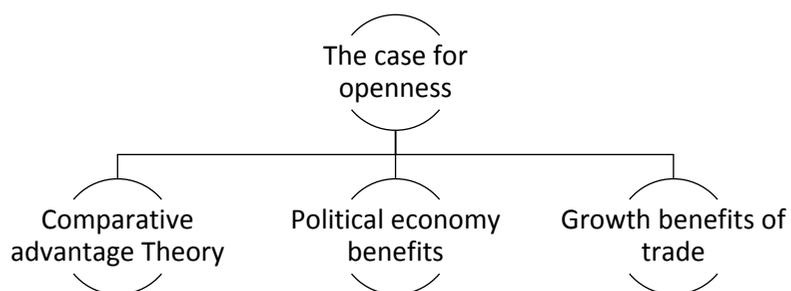
### **2.2.2. The controversy: virtues vs. limits**

EOI rose to prominence through the structural adjustment plan that was introduced by the World Bank and the IMF, and boosted by the performance of many LDCs (less developed countries) which adopted its policies during the 60s. The EOI hypothesis considers export as the main source of the government treasury and a major contributor of capital formation. Economists, especially going back to the classical authors, have considered exports as an engine of growth in the sense that it can contribute to a more efficient allocation of resources within countries as well as transmit growth across countries and regions (Lim, 2014).

First, EOI is associated with the benefit of market openness. EOI means opening domestic markets to foreign competition in exchange for market access in other countries. According to Palley (2011),

the benefits of openness rest on a combination of three contentions as illustrated as in Figure 1. The first contention is based on the comparative advantage theory which analyze the gains from trade between economies with different capital-labor ratios. The second contention concerns the political economic benefits of openness for controlling rent seeking, a problem that import-substitution development was strongly criticized. The third, which developed later, is about the benefits of openness for growth. The claim is trade encourages technology diffusion and knowledge spillovers that contribute to faster productivity growth.

Figure 1. Arguments supporting the new consensus on openness  
(Palley T. I., 2011)



Openness is also justified by neoclassical economists on the ground of allocative efficiency and economic growth. Balassa (1971) argued that export oriented policies stimulates sales. He also stated that comparative advantage leads to corresponding resource allocation which makes greater capacity utilization, permit the exploitation of economies of scale, generate technological improvement in response to foreign competition and contribute to increased employment in labor surplus countries.

Exports have been associated with growth as well as the possible positive externalities for the domestic economy arising from participation in world markets. As Thirlwall (Thirlwall, 1994, quoted in

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Felipe, 2012) states: “the growth of exports plays a major part in the growth process by stimulating demand and encouraging savings and capital accumulation, and, because exports increase the supply potential of the economy, by raising the capacity to import”. The belief of that an EOI strategy will lead to development has become a central part of the free market economic doctrine in such a way that international financial institutions like the World Bank and IMF and official government aid agencies have made producing for export (i.e. export promoting policies) a condition for providing loans or development aid. (Devi, 2014; Palley T. I., 2011)

There is a significant amount of literature that provide valuable data for analyzing the EOI strategy, especially the importance of liberalized economic policies in the growth of the economy. Balassa (1971) and Michaely (1977) found that countries exporting a large share of their output seem to grow faster than others. Eliminating trade barriers will ensure a more efficient allocation of resources. Businesses can cut costs by importing the cheapest goods available. It also encourages foreign investors to bring in new technology and capital. Examples like technological spillovers and other externalities will benefit the economy as a whole.

Another benefit of EOI strategy is that exports facilitate the exploitation of economies of scale. Classical theory believes that export as a development strategy enables development based on trade. A development strategy that promotes export encourages economies to open to international markets to capitalize on their comparative advantage to plan production more efficiently. Country can concentrate on the production of goods in which it has a comparative advantage based on its factor endowments. Resource allocation is also optimized. Thus, world trade allows the participating

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countries, both producers and consumers, to benefit from lower prices, better quality products, more diverse supply of goods and higher growth.

The product life cycle theory developed by Raymond Vernon (1966) has also attracted considerable attention. He analyzed in detail the process of how products enter the market and gradually disappear again. According to Vernon, each product has a certain life cycle that begins with its development and ends with its decline. The life span of a product and how fast it goes through the entire cycle depends on market demand, for instance, production costs, revenues and how marketing instruments are used. Many scholars have used the product life cycle theory as a basis for analyzing trade patterns. For example, Hill (2007) analyzed international trade patterns and suggested that early in a product's life-cycle all the parts and labor associated with that product come from the area in which it was invented. After the product becomes adopted and used in the world markets, production gradually moves away from the point of origin. In some situations, the product becomes an item that is imported by its original country of invention.<sup>13</sup> Segerstrom, Anant, and Dinopoulos (1990) had also made similar observations in a joint study of them on North-South trade.

Of the many studies on EOI, the majority focuses on the causal link between exports and output growth in developing nations. Michaely (1977) and Balassa (1971) agreed that export growth brings

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<sup>13</sup> A commonly used example of this is the invention, growth and production of the personal computer with respect to the United States. (Hill, 2007) In the new product stage, the product is produced and consumed in the U.S.; no export trade occurs. In the maturing product stage, mass-production techniques are developed and foreign demand (in developed countries) expands; the U.S. now exports the product to other developed countries. In the standardized product stage, production moves to developing countries, which then export the product to developed countries. This model demonstrates dynamic comparative advantage. The country that has the comparative advantage in the production of the product changes from the innovating (developed) country to the developing countries.

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about overall economic growth. Love and Chandra (2005) confirmed the positive role of export-led growth in the development of the South Asia region. Mehrara and Firouzjaee (2011) also tested the EOI hypothesis by collecting data from 73 developing countries during the period 1970-2007. Some economist tested the strategy in different economies such as the UK, Canada, and the USA etc. and provided evidence to support the proposition that export enhances growth as well as productivity (Serletis , 1992; Awokuse, 2003).

After carefully reviewing many articles based on various case studies from both the macro- and the micro- levels, Fu (2004) states that exports do not necessarily lead to growth. Rather, the transmission mechanisms are important. In general, growth of exports stimulates demand, encourages savings and capital accumulation, and strengthens on economy's supply capacity by increasing its import capacity, thus contributing significantly to economic growth. Yet Fu (2004) finally remarks that cross-country studies cannot yet provide enough information on the exact transmission mechanisms. Only careful case studies can provide more compelling evidence. The most interesting economic scenarios suggest a bilateral or feedback relationship between growth and trade. (Yin, 2002; Papageorgiou, Choksi, & Michaely, 1990) They interact with each other. Growth in GDP facilitates growth in trade and vice versa.

The EOI strategy has also received considerable debate (Palley T. I., 2003, 2011; Fu, 2004; Gibson & Ward, 1992; Lim, 2014; Love & Chandra, 2005; Papageorgiou, Choksi, & Michaely, 1990) which will be summarized below: First, EOI creates dependence on foreign markets. EOI strategy is highly dependent on foreign demand. To achieve export-oriented growth, a country has to cater to the size

and structure of demand in their most important export markets. The country is also highly dependent on gaining access to the designated export markets (Lim, 2014). For example, if a country plans to export a million TVs, this can only work if there is a demand for a million TVs somewhere in the world. Further, the governments of those foreign markets have to be free from steep importing taxes that can raise the price to a level that kills the domestic demand. This strategy can also lead to dependence on imports of key inputs (energy, raw materials, semi-manufactured goods, technology) directly or indirectly used for a country's competitive exports. The degree of dependence may be higher if the country's exports and imports are concentrated on a few markets and a few suppliers.

Second, EOI creates neglect of domestic priorities. Since overseas demand and domestic needs won't match exactly, the production capacity for export cannot be used to meet domestic needs (Love & Chandra, 2005). Countries export goods based on their comparative advantage and they import goods that would be more expensive (or impossible) to produce at home. An export-oriented strategy will make a country's production focused on overseas demands, not their own. When overseas markets are steady and the money keeps flowing in, there will not be a problem, as the money can finance domestic development and pay for the imports that people do need. But the international market is a complex condition whose reliability depends on many variables. An incident like the global financial and macroeconomic crisis of 2008-2010, where most overseas markets were shrinking or even closed off, a country may be left with a production capacity that cannot be applied to domestic needs --- a million TVs with no one to export to.

Third, EOI creates wage suppression. The comparative advantages for developing countries are

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primarily their cheap labor, which lowers the cost of products they produce and makes a competitive price in the international market. For example, we can find a lot of T-shirts sold in North American stores that are made in countries such as Vietnam or China. This is not because Vietnamese or Chinese workers make better shirts than local workers, but because their pay is so much lower that it is cheaper for T-shirt companies to make shirts there and ship them to North America than it is to make shirts locally. Then, it is in the developing countries' interest to keep labor costs low in order to sustain their export-oriented growth. Wage growth is restrained. People of the country will have difficulty enjoying the very prosperity that export-oriented growth is supposed to bring about. Palley (2003, 2011) further remarked that chasing minimum cost encourages a political dynamic, both within countries and across countries, that is aimed at lowering standards across every dimension, including work conditions and the environment.

And fourth, limited opportunity and sustainability of EOI. Some economists (Fu, 2004; Palley T. I., 2003) call export a zero-sum game. Every item that is exported by one country has to be imported by another. Growth will not happen if all use an export-oriented growth strategy because no one will be importing. Further, the export-oriented growth model was criticized for assuming countries can grow by relying on growth of demand in other countries (Gibson & Ward, 1992; Palley T. I., 2003, 2011; Yin, 2002) which lead to global excess supply and deflation. Palley (2003) commented on this argument and state that:

In this connection, it is not exporting per se that is the problem, but rather making exports the focus of development. Countries will still need to export to pay for their imported capital and intermediate goods needs, but exporting should be organized so as to maximize

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its contribution to domestic development and not viewed as an end in itself. (p.2)

Export-oriented growth is also not a sustaining strategy. Wage suppression for securing cheap-labor advantage in export markets contradict to economic growth to raise living standards, which means higher wages. This is especially true for those low-value added, low technology manufactured goods exporting countries. When competitions become who can provide cheaper labor, and because it is so easy for multinational corporations to shift production between countries, this create the problem of a global “race to the bottom”:

Developing countries are trying to get competitive advantage through a combination of wage suppression; suppression of labor, environmental and social standards; suppression of business regulation; shifting of tax burdens onto labor income away from capital income; creation of extra-judicial export processing zones; and competitive devaluations that create financial instability. Since all do it, none gains significant competitive advantage. This destructive competitive dynamic undermines the development of standards, institutions, income equality, and wage growth that are needed for deeply rooted development. (Palley T. I., 2011, p.16)

The above mentioned analysis made some economists (Palley T. I., 2003, 2011; Lim, 2014) view the export-oriented growth paradigm as questionable and tend to exhaust. On top of this, because export is deemed as a zero-sum game, there is argument that it is impossible to raise overall world growth with export as it merely changes each country’s growth composition.

There are, however, also arguments against this allegation. He, Zhang, & Chang (2007) studied the growth pattern of China as well as other East Asian countries who have also adopted the export-led growth model. They asserted that this allegation confuses the impact of foreign trade on the trend of an economic cycle and its long-term growth potential. In the long run, economic growth is driven

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by technological progress rather than demand. When a country liberalizes its market and enters its products into the world market for competition, it will be forced to seek out and adopt the most efficient and cost effective production and management know-hows. This technology and knowledge spillover and other positive spillover effects that come with opening for trade are the major determinants of export expansion leading to growth. From this perspective, export-oriented growth strategy is not necessarily a zero-sum game. Rather, it has a positive-sum character. In theory, every economy can export some goods and services and import others, and use both exports and imports for upgrading and thus for productivity growth. Hence one country's adoption of export-oriented growth strategy will not damage another's interest. Everybody can participate and this is the essence of the export-led growth strategy. This is also regarded as the basic aspirations of Asia's growth miracle.

The success of export-oriented growth model should not be measured only by trade surplus or deficit. From a dynamic perspective, both imports and export can act as a vehicle for upgrading the economy and each other and thus to further living-standard improvement. (He, Zhang, & Chang, 2007) Exports not only contribute to growth in the export sector, but also bring about growth effects in the economy as a whole by enabling a more productive use of its resources through technology advance and economy of scale from exploring comparative advantage. (Benner , 2011) Imports could work as means of acquiring productivity-enhancing equipment, know-how, and foreign human capital etc. to achieve technology transfer. These mechanisms do not necessarily presume a surplus in trade. After all, it is important to maintain a strong and competitive exporting sector, but not that more is being exported than being imported.

Under the trend of globalization, to some extent, every economy is bound to gain revenue through exporting what they have comparative advantage and importing what cannot be produced in the country itself, e.g. due to a lack of capital or know-how. It is thus unwise to reject either export or import completely. The political and business leadership of the country should use the money earned from export to develop the economy to avoid possible over dependent on exports. This is also the way to bring up wages and living standards without cracking the economy. This requires delicate balancing of import and export.

In light of the not long ago global financial crisis as well as the obvious drawbacks of relying heavily on export sector for domestic growth, some measures were proposed for remedy to achieve a more balanced growth for overall development. Successful and sustained growth requires growth in both domestic demand and net exports. Economy formerly focused on export-oriented strategy should consciously make certain transition and shift some growth focus to domestic demand-led growth. To achieve this, countries need to restructure not only their distributive and redistributive regimes but also their production structure. Measures proposed by many (Devi, 2014; He, Zhang, & Chang, 2007; Fu, 2004; Lim, 2014; Palley T. I., 2003, 2006; Guo & N'Diaye, 2009) include:

1. Upgrade a country's comparative advantage by moving out of labor-intensive industries into higher value added industries, and make growth based on technological rather than wage competitiveness.
2. Further export expansion by, for example, moving up the value-added chain, shifting the composition of exports, diversifying the export base, and increasing domestic value added of exports etc.

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3. Recalibration of development policy. It is argued that reliance on domestic demand generates more sustained value addition than exports. Thus a shift of focus from export-led towards domestic demand led strategy should be explored penetrated for national goods. To make this happen, the solution is to raise domestic consumption much faster than has been the case so far.

4. Rebalance growth toward private consumption. For example: revalue country's currency, raise wages and improve income distribution.

5. Government policies should target towards protecting and enhancing domestic consumer spending since appropriate growth in consumption means improvement of the population's welfare.

6. Develop sustainable domestic purchasing power. Since it is important to keep an adequate investment levels in order to grow and develop, when facing decline in export growth, by expanding domestic household consumption, growth rate can be kept unchanged.

### **2.3. China's urban centered export-oriented growth**

China had a nearly average of 10 percent GDP growth per annum since 1978. Millions of people have been lifted out of poverty and China has since embarked on a new journey with greater economic performance, higher productivity and growth than in the pre-reform period. Nevertheless, it is also recognized that China's growth has been labor and resource intensive.<sup>14</sup> In recent years, growth has also been associated with rising inequality (Benner , 2011; Devi, 2014; Fu, 2004; Guo & N'Diaye, 2009; He, Zhang, & Chang, 2007; Lim, 2014; Papageorgiou, Choksi, & Michaely, 1990; Kuijs & Wang, 2005;

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<sup>14</sup> For example, industries heavily draws on physical capital, energy, and natural resources.

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Xu, 2011) with a widening rural-urban income divide, and ever aggregating demands on energy, water and other natural resources, the quality and sustainability of China's EOI growth pattern was greatly questioned.

### **2.3.1 The transition to an export-oriented economy has contributed to China's economic leap**

Before economic reform and trade liberalization, China was a closed economy that had been pursuing a domestic import substitution strategy. During this era, China advocated "self-sustain and self-reliance" and focused on developing domestic production in replacement of most foreign import. (Xu, 2011) Through tariff and trade protection, some raw material industries and heavy industries have been developed. Exports, with their focus on agricultural products and mineral products, was designed to merely generate sufficient funds to meet basic import needs. This development strategy, though help to protect and develop some basic industry, was low in efficiency and productivity. Further, the whole economy's operation is under administrative command. This disregarded the nature of the market and created price distortion and less efficient resource allocation. China was an economy with a low competitiveness, a shortage of fund, technological stagnation and weak national economic growth.

China took up the experience of Japan as well as other Asian countries' economic success after the Second World War and started its own economic reform in 1978 by pursuing an export-oriented industrialization strategy. Due to its size, a large economy like China has great factor endowment and huge reservoirs of surplus labor. The reform period also coincided with the period when developed countries sought to transfer labor and resource-intensive industries to developing countries (Balassa,

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1971). This provided a great opportunity for China's development of labor-intensive industries and was a starting point of its EOI strategy.

The EOI strategy has brought China many important achievements. First, EOI brought economic growth. With the expansion of trade, China's GDP has also experienced a leap-style growth. China's total import and export in 1978 was only 20.6 billion US dollars. In 2014, total imports and exports reached 26.4 trillion US dollars. China's GDP in 1978 was 218.5 billion US dollar and the figure in 2014 turned to 10,483.40 billion US dollar. That is an increase of 47 times (National Bureau of Statistics of China, 2016). There is no doubt that foreign trade has become an important driving force of China's economic growth.

Second, EOI has promoted employment. Trade has changed the number and structure of employment in China. China mainly exports labor-intensive products such as electrical, mechanical, and textile products. The low labor costs give China considerable advantage in international competition thus earning China a huge share on these markets. Labor-intensive industries absorb a large amount of employment. Export trade has created 100 million jobs, accounting for 1/7 of total employment in China (Xu, 2011).

Third, EOI has promoted the economies of scale. With export expansion, China's international market share increased. Improved market capacity allows enterprises the opportunity to explore economies of scale. At present, China's output of 172 kinds of products has been ranked first among others in the world. These include agricultural products, industrial products, electronic products and general consumer goods. Among them, the laser disc player, tractors and containers production

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accounted for more than 80% of world output (National Bureau of Statistics of China, 2016). A large proportion of these are for export. Expansion of the export sector has not only allowed enterprises to achieve economies of scale both externally and internally, it has also been beneficial to related industries through demand.

And fourth, EOI has promoted industrial upgrading and structural optimization. Development of trade has changed the ongoing protection of backward and inefficient sectors of the economy. Economic factors are prompted to flow into more efficient industries. Market demand has helped to sort out and eventually gradually eliminate traditional backward industries. New industries continue to emerge. Trade also promotes knowledge share and technological advance. China has changed from the traditional pattern of exporting mainly primary products. Industrial products become the main export products and high-tech products rising its share in export (Zhang & Zhong, 2009).

### **2.3.2. Necessity for the transformation of China's urban centered export-oriented economy**

There is no doubt that the transition to an export-oriented economy has contributed to China's economic leap. Nevertheless, with the continuous expansion of China's economic scale, this model has started to show many drawbacks which pose as obstacles to further the development of economy. They can be summarized as 5 points:

First, resource and environmental bottlenecks.

China's large territory is blessed with a great resource endowment. However, even though China ranked third in the world for its general resource reserves in 2007, the per capita possession of resources is less than half of the world's per capita possession where China only ranked fifty-third

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(Zhang & Zhong, 2009). There has been a serious shortage of important resources such as oil and natural gas.<sup>15</sup> China's total oil consumption in 2007 was 349 million tons, 211 million tons of which were imported, which is a 60.6% dependence on import. Other energy or mineral resources also has limited or inadequate domestic supply capacity.<sup>16</sup>

EOI growth tends to be an excessive plundering of nature, with very adverse consequences on the quality of life. China at present is a prime example.<sup>17</sup> Resource exploitation and utilization as well as acceleration of industrialization and urbanization all have caused great environmental pollution including water pollution, air pollution, solid waste pollution etc. According to the World Bank (Xu, 2011), China's annual GDP loss due to environmental pollution has reached 10%.<sup>18</sup> More than 70% of rivers and lakes in China are polluted to a various degree. More than 20% of the urban population lives in polluted air. Solid waste has multiplied (Zuo, 2007). There have been signs already that the speed of pollution exceeds the environmental capacity, which means the speed of environmental self-purification cannot keep up with the speed of pollution.

Environmental destruction and pollution in China is of course caused by many factors, but the EOI growth strategy shares a major part of the responsibility. The energy consumption and environmental pollution caused by the secondary industry is higher than those in the primary and tertiary industries.

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<sup>15</sup> The per capita possession of these resources is only about 7% of the world. Even the relative abundant coal reserves only account for 64% of the world's per capita coal possession. (National Bureau of Statistics of China, 2016)

<sup>16</sup> According to the study of current reservation of 45 key strategic resources for industry by the National Bureau of Statistics of China (2016), it is estimated that by 2020, China will have 9 kind of resources in serious shortages that will have an import dependencies over 70%. There are also 10 other kind of resources will have a 40% to 70% import dependency.

<sup>17</sup> Some other Asia countries, like Thailand, also shows the effect. (Zhang & Zhong, 2009)

<sup>18</sup> For example, China's southeastern coast account for several of the world's most serious acid rain pollution region. Pollutions like this account great cost when manifested into GDP amount.

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Industrial products, which are both pollution-driven and high in energy-consumption, accounted for the vast majority of China's exports. For example, in 2006 China exported 36.13 million tons of cement and 43.01 million tons of steel (Zhang & Zhong, 2009). The expansion of international trade both in volume and variety continually add on to the energy and resource tension.

China's overly emphasized on maintaining a low cost comparative advantage through mainly engaging in labor-intensive production that slowed down China's industrial upgrading, scientific and technological progress, and reduce innovation. This has also affected China's rational allocation of resources, and reduce the incentive to protect the environment. For example, China has less strict environmental regulations to promote industrialization by keeping the prices of energy, electricity, utilities (including water), and land low (Kuijs & Wang, 2005). In the province of Zhejiang, the government has subsidized coal usage for power generation. This has created cheap electricity and continues to encourage the establishment of electricity-intensive industries (Zuo, 2007).

Second, increased international frictions.

According to a press conference held by China's Ministry of Commerce (MOC) on April 8, 2013 (China Briefing, 2013), trade probes targeting China are becoming more frequent and complicated, and resolving trade friction will be a long-term and challenging task for the country.<sup>19</sup> "Increasing

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<sup>19</sup>For example, in 2012, 21 countries initiated 77 trade remedy probes against China, involving US\$27.7 billion in total. Furthermore, in the first quarter of this year, 12 countries have already launched 22 investigations relating to trade remedy measures against China, involving US\$963.7 million in total. From 2002 to 2012, China was hit by 842 foreign trade remedy cases, including 621 anti-dumping cases, 61 anti-countervailing cases, 124 safeguard measure cases, and 36 special safeguard measure cases. The amount of money involved has totaled US\$73.6 billion. In addition, there have been 130 "Section 337 investigations" launched by the U.S. International Trade Commission, which are mainly related to claims over intellectual property rights. (China Briefing, 2013)

trade friction is an accompanying phenomenon as China has become the world's second largest economic entity and a big trade country," said Song Heping, an investigator at the Bureau of Fair Trade for Imports and Exports of the MOC. "The outlook for trade-remedy investigations targeting China is not optimistic as increased trade friction will likely become more normal, and exporters are facing a very complex trade environment" (China Briefing, 2013). The Global Financial Crisis has caused growing trade protectionism from its aftermath. While the global economy stagnated, China still maintained a relatively fast rate of growth amid sluggish global demand which making the country an easy target for trade protectionism (China Briefing, 2013). This also add to the escalating trade friction of Chinese trade.

Third, diminishing comparative advantage.

China's labor costs can hardly be maintained at such a low level. The price of agricultural products, health care, education, and housing etc. contribute to the rising cost of labor. These prices have a long-term upward trend which is bound to push up labor costs. Thus labor prices have a rigid upward tendency during economic development. Chinese economist Yang Li (Zhang & Zhong, 2009) believes that China's demographic turning point will arrive in 2015 or so, followed by a continuous decline in population with a large proportion aging population. China's labor force will shrink dramatically.

China has taken advantage of its labor-intensive, mass production of economies of scale and fully exploited its huge competitive advantage in the international market. This is bound to have an impact on other economies with competing industries, resulting in the shrinking or even a complete threat to

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the survival of their industries.<sup>20</sup> Meanwhile, China is also facing the ever fierce challenge and competition from many other developing countries such as India, Vietnam, Brazil, and Pakistan that are at the same stage of development as China and also focus on labor-intensive industries. This raises the problem of a global “race to the bottom” (Palley T. I., 2003, 2011). Further, China’s huge foreign exchange reserves are putting enormous pressure to appreciate on the Chinese Yuan which also adds up to diminishing cost competitiveness. An EOI strategy that is based on sacrificing the environment, resources as well as workers’ welfare is not sustainable and in urgent need to change.

Fourth, domestic contradictions.

There are three kinds of contradictions created by China’s urban centered EOI strategy that are summarized next:

The first kind of contradiction is between labor and capital. Globalization, mainly the increase in world trade, allows capital to flow freely to places where wages are low, putting pressure on the bargaining power of labor both in the rich and poorer countries (Lim, 2014). China’s foreign trade mainly involves products in the lower-end of the product chain which have inferior in risk-shifting ability and inferior product pricing power. In order to maintain an advantage in international competition, the government pursues policies that repress labor and wages in order to attract foreign investments. On top of this, some local governments further suppress production costs by reducing necessary labor and equipment investment, and limit the social welfare input. There are many reports

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<sup>20</sup>For more discussion, refer to the previous part’s discussion about EOI strategy’s “zero-sum” character as well as the discussion on EOI’s character of unsustainability.

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regarding how workers are asked to work overtime in a poor working environment in order to catch up to the factories' international orders (Zuo, 2007). And for considerations of economic growth, the introduction of foreign investment and other performance aspects, some local level governments tend to favor employers more than workers in disputes.<sup>21</sup> This further reflects a weak implementation of labor laws and regulations which often damage the legitimate rights and interests of workers (Zhang & Zhong, 2009).

The second kind of contradiction is between the export and non-export sides. In an export-oriented economy, the export sector is the main beneficiary of export earnings. However, in order to protect the export-oriented economic development, labor and resource prices are kept artificially low, which is a burden on the environment and all of the people. Further, exchange rates are also kept artificially low which leads to higher import price. China rewards exporters with a high export tax rebate, while imported products are taxed relatively high. Domestic income growth is weak. People cannot enjoy the benefits of imports. This asymmetry of income and cost exacerbates the contradictions between domestic exporters and non-exporters. Further worth notice, tax rebates on export represent an outflow of national welfare.

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<sup>21</sup> See for example, a report on coal workers complaining employee for withholding wages and benefits. (<http://www.rfa.org/cantonese/news/labor-08232016084403.html>);

Discussions the impact and solutions for discriminating regulations against migrant workers. (<http://theory.people.com.cn/GB/40557/49139/49143/3511484.html>);

Report on the EOI strategy implementation and the SOE laid-off workers. SOEs were given freedom to evaluate their employees and take corrective actions including dismissal of employees, while the social security system for laid off workers is far from sufficient.

(<http://www.voachinese.com/a/china-labor-reform-20160318/3244619.html>)

The third kind of contradiction is between urban and rural. Michael Lipton, who coined the theory “urban bias”, is probably one of the most famous researchers in analyzing the rationale of rural-urban differences’ formation and its consequences. In his book *Why Poor People Stay Poor* (Lipton, 1977), he argued that less developed countries tend to put development focus on urban over rural as rural is not usually deemed as having great potential for economic progress. Urban development and industrialization are usually funded by drawing resources from rural. This drawing process is backed by government policies such as taxation and public spending preferences. Government make economic policies and institutional arrangements in favor of urban. Public spending tend to concentrate on the development of urban areas and on industrial growth and resources tend to be allocated to towns and cities as opposed to villages. For one reason, it is because urban residents hold more political power over rural residents so that policy making are influenced in favor of urban interest. For another reason, it is historically a fact that industrialization tend to concentrate in urban areas since its many advantages over rural such as cities are the focal point of information, it has better communication, it is focus point of event and resources etc.

Urban bias can very well be used to describe features of China’s urban-centered EOI strategy. The government direct policies to keep goods and services from rural areas (for example, food) underpriced and those from urban areas over-priced. Financing was channeled on favorable terms to investment in industry, particularly to large enterprises and/or SOEs. Public spending is disproportionately allocated to urban areas, particularly in health and education, while poor rural residents are disadvantaged in terms of education, health, nutrition, technology, and access to

financial services. Further, labor movements were restricted due to the Hukou system (Kuijs & Wang, 2005) thus created income and welfare differences between rural and urban.

Lipton (1977) summarized that urban bias will lead to a rural skill drain since the wage differences between urban and rural draws the manpower away. Further, urban bias stops possible formation of valuable rural-urban links. He suggests that successful pro-poor development would require a much larger share of resources for rural areas and farming. For the prospect of China, as it is rural population still consists the majority of its entire population, it is both not fair and efficient to have the towns and cities enjoy a far larger share of national resources.

And fifth, over-dependency risks.

China's export dependency was 18% in 1998, and it rose to about 38% in 2007 (National Bureau of Statistics of China, 2016). Some considerable part of Chinese industries are export-oriented. They are influenced by the international market. Thus, China's smooth and high-speed growth largely depend on the stability of international markets and the global economic prosperity. Any fluctuations in the international market will quickly affect China. Such growth faces great potential risk due to very low household spending among people in China. Wages suppressed for export-oriented growth have suppressed the development of China's domestic market, which cannot absorb the excessive goods that cannot be exported in the event of low export demand.

There is also an argument that China's existing strategy is fundamentally flawed, owing to its reliance on an export-oriented growth that is powered principally by a U.S. market which is fueled by debt. (Palley T. I., 2006) China has become the largest holder of US Treasury bonds. Whenever the

dollars depreciate, China's foreign exchange value shrinks greatly.

### **2.3.3. Transformation approach suggestions on China's export-oriented economy**

An adjustment of export-oriented development strategy is imminent. But this does not mean to simply reverse back to the pre-reform import substitution strategy. The international market and international resources are still necessary for China's economic development. Therefore, China must find a path that, while continuing to strengthen its exports by shifting from a comparative advantage to competitive advantage, raises domestic consumption power. This requires the focus of economic development to shift inward.

The main objective of a country's economic development should be to increase the welfare of its residents and to develop productivity, rather than only pursuing trade and GDP growth. A moderate level of protectionism is advocated (Xu, 2011).

Measures proposed can be summarized into three points:

First, adjust income distribution, promote domestic consumption and expand domestic demand (Cao & Zhang, 2015; Chen & Wang, 2013). At present, the main reason for the lack of domestic consumption is the uneven distribution of income among domestic residents. Enterprises' share of the distribution is too high. Income disparity among regions, between urban and rural residents is too large. Therefore, adjusting the distribution pattern is key to promoting growth in consumption in China. Residents' income should increase gradually in proportion to the national income. Increase the disposable income of the residents, especially the low-income group. At the meantime, reduce the share of income of the state and enterprises. The distribution should focus on fairness and balance

income differences. It is also needed to establish an improved social security system for both urban and rural areas. These measures can all help increase domestic consumption and raise national welfare.

Second, enhance economic self-development capacity by shifting comparative advantage to competitive advantage through technological upgrading and management innovation (Atinc, 2010; Fu, 2004). Further focuses should be on improving the technological content of products and its added value. Scientific and technological innovation help optimize and upgrade industrial structure as well as bring internal economic development momentum. To stimulate enterprise technological innovation, there is need to reduce various institutional obstacles, to reduce the cost of technological innovation, and to strengthen the protection of intellectual property rights. Piracy violations and counterfeit products should receive significant penalties in order to ensure a higher return for technological innovation. The government could use different standards, such as technical standards, environmental standards, and safety standards to measure competitiveness, and phase out incompetent products. Government should also increase investment in research as well as encourage private research and creation. Meanwhile, technological exchange and cooperation enterprises with domestic or international partners will also foster overall technological advancement, expand capacity and achieve a higher scale of production.

And third, adjust trade structure to better serve domestic economic development (He, Zhang, & Chang, 2007). For example, when facing foreign capital, it is necessary to gradually raise technical barriers and environmental barriers to encourage the entry of high-tech and new industries. Promote balance of imports and exports by gradually expand the proportion of imports. Import of foreign high-

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tech products can also help technological renovation, and promote productivity.

### Chapter 3. Data Analysis

Nearly seventy years ago China started a planned development of its economy.<sup>22</sup> It adopted the Soviet model of industrialization characterized by radical land reforms leading to collectivization. Whatever the merits, it has burdened the economy with costly defects, some inevitable in any planned economy, others unique to China. China's productivity and growth potential was constrained and only delivered modest gains at best. In recognition of the government's internal self-reflections over past experiences as well as the magnificent transition and economic success in neighboring East Asian countries (e.g. Japan, South Korea, Singapore), in 1978 China changed its path in favor of a "socialist market economy" which was characterized by a focus on de-collectivization and "open door" policy for foreign trade and investment (Deng, 1993).

After the successful implementation of the household responsibility system in the rural area, the state further extended the market economic reform from agriculture to the whole economy by adopting an urban centered export-oriented industrialization strategy. This initiative was a great success in terms of generating substantial income and stimulating growth at a speed that filled the rest of the world with astonishment. Market mechanisms played a central role in increasing labor efficiency and resource allocation, both of which helped productivity surge tremendously. Yet wages were kept low due to a large supply of labor and national policies that were biased against rural and migrant

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<sup>22</sup> Also referred in different places as "centrally planned", "soviet type" or "command" economies.

workers who worked in cities but were denied with equal payment and social and economic services. In 2002, after four decades of industrialization, the average hourly wage in China's manufacturing industry was only 3% of that in the U.S. (Shi, 2012).

In recent years China became increasingly exposed to external pressures like currency appreciation, trade protection, and internal pressures like inflation, income disparities, and environmental degradation. These pressures are closely related to some major drawbacks created by following an urban centered export-oriented industrialization strategy. China's low domestic consumption power is a major problem since it makes China vulnerable to international market fluctuations because there is no strong domestic market to resort to at times of crisis such as the 2008 world economy crash and the accompanying Great Recession. With a weak domestic consumption power and an over dependency on export, China is confronted with a troubling outlook of shortage in demand.

The research of this thesis focuses on China's urban-rural difference caused by the urban centered EOI strategy since its economic reforms in 1978. The purpose of this study is to examine whether China's urban centered export-oriented economic reform strategy is the reason for current urban-rural income disparities which have led to a low consumer purchase power, shrinking domestic market as well as a dependency on international markets. This helps to answer the research question: what will be most likely development outcome if China continues to carry on its urban centered, export-oriented industrialization strategy? While my data is collected mainly from official sources such as the National Bureau of Statistics of China (NBSC), the United Nations, and

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the World Bank database, and it is supplemented by data from some key studies as well as relevant news reports. Data collected for this thesis are dated from the year 1978 to 2014.

### **3.1. The size of China's rural population**

In order to find answers to the research question, it is necessary to provide definitions of rural and urban in the context of China. It is also important to look at the numbers of rural residents and rural rooted migrant workers since only a considerably large proportion of the rural population would have enough influence to affect the domestic purchase power.

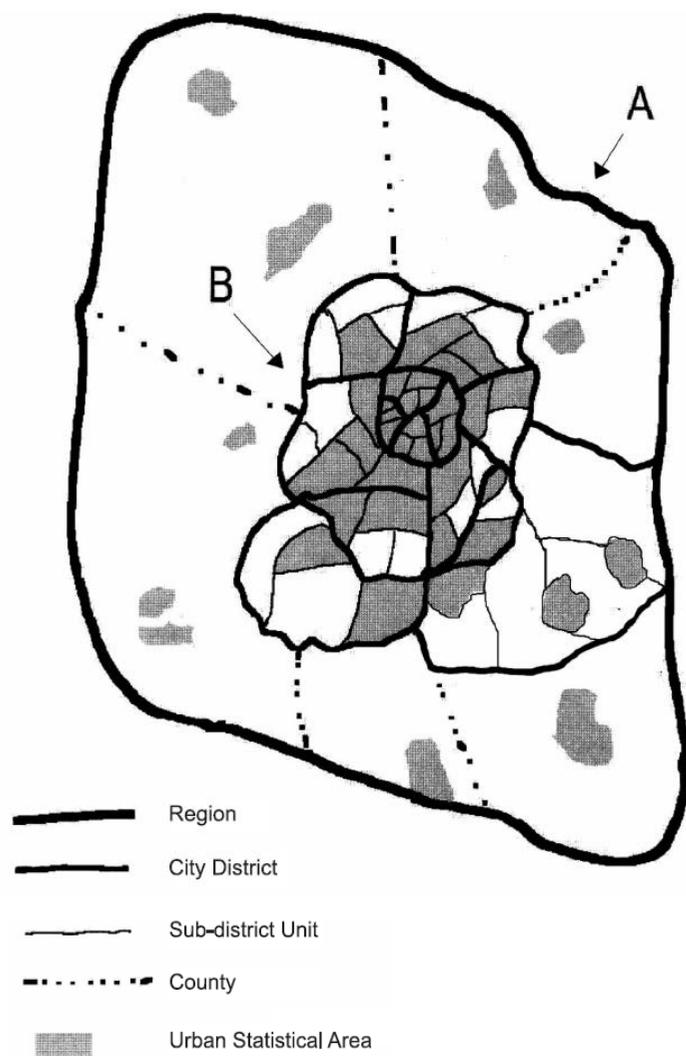
#### **3.1.1. Rural and urban division**

The word "urban" is closely related to key words like: city, metropolitan, administration, and central, while the word "rural" is closely related to key words like: suburb, countryside, agriculture, remote. Then how to define urban and rural in terms of their geographical border?

A city is a non-agricultural economic system that indulges its residents' daily activities. Nearly any sizeable city contains an "urban core" and a continuous area of residential and industrial "suburbs". All of these together make up the "city" as a unit of analysis. Such cities' real borders often reach beyond its administrative boundaries. Many large cities in the developed world, due to highly developed traffic systems, usually consist of a wide range of suburbs. Suburban functions and the urban core are closely related. There are daily commuting from suburbs to the urban core through transportation links such as highways, railways, etc. The whole area forms an integrated "metropolitan area". Tokyo, for example, is recognized as one of the world's largest city. Tokyo here should be actually referred as the "Tokyo Metropolitan Area", not the administrative area of Tokyo. Its metropolitan area has a total population

of more than thirty million people (Chen J. , 2010).

Figure 2. Concept map of Chinese urban composition (Chen J. , 2010)



In general, many Chinese cities, or they should be actually referred as big “urban districts” (area A plus area B in Figure 2) to be more precise, normally cover a wide geographical area that consists of the city core (area B in Figure 2), which contains the highest density of infrastructures and economic activities, and the peripheral county area (area A in Figure 2), which contains mainly residential

communities. The peripheral county area often expand into surrounding towns or villages with a predominantly agricultural economy. The city core is characterized as urban while the peripheral county area is characterized as rural. As a result it is hard to draw a precise boundary between the rural and the urban as these area are most of time tangled both geographically and demographically, as indicated in Figure 2, most of the “urban statistical area” falls into area B with some small areas scattered around. The NBSC (2015) defined urban regions as areas that either have a population density of equal or more than 1500 person per square kilometer, or with a population density lower than 1500 person per square kilometer that contain either a city’s government body or county jurisdiction. This definition will be used in this thesis to statistically calculate the rural and urban population.

### 3.1.2. Rural and urban population

Table 1. Population and its composition (NBSC, 2015)

Year	Urban		Rural	
	Number (million)	Percentage %	Number (million)	Percentage %
1949	57.65	10.64	484.02	89.36
1978	172.45	17.92	790.14	82.08
1990	301.95	26.41	841.38	73.59
1995	351.74	29.04	869.47	70.96
2000	459.06	36.22	808.37	63.78
2005	562.12	42.99	745.44	57.01
2010	669.78	49.95	671.13	50.05
2011	690.79	51.27	656.56	48.73
2012	711.82	52.57	642.22	47.43
2013	731.11	53.73	629.61	46.27
2014	749.16	54.77	618.66	45.23

Table 2. Floating population in China (NBSC, 2015)

Year	2000	2005	2010	2011	2012	2013	2014
Number (million)	121	147	221	230	236	245	253

Table 1 shows China's population and its rural-urban composition in various years. In 2011, the urban population has reached 656.56 million and surpassed the rural population for the first time in Chinese history. The urban population has kept expanding since and signaled the great progress of urbanization in China. The main reason for the increase of the urban population can be attributed to rural to urban migration. According to the NBSC (2015), the major increase of population in urban statistical areas has resulted from migrant workers. They are categorized as the "floating population". Table 2 shows the number of floating population over various years. By official definition, the floating type of residents, compared to permanent residence, are those who are in the area (mainly due to work) but do not live there permanently and have registered their "Hukou" elsewhere.

Problems arise when combining Table 1 and Table 2. Even though the statistics in Table 1 shows an urban population turning point in 2011, if adjusted with the floating populations that are actually rural rooted (Table 2), the true urban population is brought down from 690.79 million to 460.79 million which compose of only 34.20% of total population instead of 51.27%. According to the NBSC<sup>23</sup>, in 2013 the Hukou registered urban population compose of 35% of total population which matches with the

<sup>23</sup> See for a number of report regarding the real and statistical difference on population calculation. For example: "Experts advise to recognize the pseudo-urbanization". (<http://www.chinanews.com/gn/2013/07-05/5010062.shtml>); "China's real urbanization rate of Hukou household registration" (<http://news.sina.com.cn/c/2013-11-05/043028620661.shtml>).

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above calculation. Until 2014, the adjusted urban population only accounted for 36.27% of the entire population.

As China continues its economic reforms by deepening its commitment to export-oriented industrialization, structural changes and shifts of labors between sectors have created confusion and difficulties on accurately defining rural and urban population. China had a large pool of surplus labor that occupied the low-productivity agricultural sector. Fast economic growth and industrialization drew them into the non-agricultural sectors, where employment increases rapidly. In the process, these migrant workers, though statistically counted as urban residents. Their real Hukou household registration and social welfare entitlements still remain rural based.

### **3.2. Economics of domestic consumption vs. exports in GDP growth**

Consumption, investment and trade are three component of GDP. They exist independently, but also interrelate and interact with each other. If domestic demand is weak, domestic supply of products may be exported, thus stimulating growth of export. Export growth will lead to equipment renewal and output growth of related industries, thereby expanding the scope of export related investment and consumption. Export also affects the structure of import since import need to satisfy related consumption and production needs. And vice versa, if international demand is not strong enough then it will causes a corresponding reduction in export related investment and consumption. Export commodities will need to turn to domestic market and hence there is the need to alter the production structure to make the products more suitable to satisfy domestic market. And of course, the structure of import will also change accordingly. In both scenario, whether there will be a GDP growth depends

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on how these components interact. And these are influenced by international markets conditions and domestic policies. An overall assessment of the impact of exports on economic growth requires a comprehensive examination of the transmission mechanisms.

In a dynamic point of view, the role of foreign trade is not merely to push up a few percentage points of GDP growth, but for the more important functions such as to achieve optimal allocation of resources, to transform and upgrade growth structural, to maintain international balance of payments and exchange rate, to introduce foreign advanced technology and modern management know-how, as well as to foster innovation and provide employment opportunities.

Trade growth, especially export growth, has always been associated with GDP growth. It is not only because export itself can generate substantial income for an economy, but also the transmission mechanism that stimulate export related investment and consumption. This worth a careful re-examination. In a scenario that an economy has large domestic demand that resorting only to domestic supply won't completely satisfy. This economy is short of supply. Then an increase in import can supplement domestic supply and immediately translate into domestic consumption and investment, thereby boosting GDP growth. In this scenario, export, however, will reduce domestic supply and counteract with domestic consumption. Even if there is any increase in export, the increase will likely be lower than the increase of import. And increase of export will actually reduce trade surplus or even create deficit. This explains why sometimes an economy with a low or even negative net export still has a rising GDP growth rate. Similarly, when domestic supply is high and effective demand is insufficient, there is a relative excessiveness of products that seek foreign demand. In this case, net

exports reflect the net demand of foreign markets for domestic products. Trade volume tend to expand and export growth rate tends to be higher than that of import. Export growth will create trade surplus and bring up GDP growth.

Export-oriented strategy had brought China rapid growth over the past few decades, yet it also increased China's dependency on the highly uncertain global conditions and markets. This vulnerability was exposed by a hard way of the 2008 global financial and macroeconomic crisis and depression. There are suggestions that policy alterations should be made on turning the focus to domestic market for growth.

Consumption also has an immediate impact on GDP which is also another component of it. When other conditions being equal, an increase in consumption raises GDP by the same amount. In addition, GDP is an important determinant of consumption as well. GDP growth means a higher income thus trigger a rise in consumption. And rising consumption in turn will boost GDP growth. A positive interactive mechanism between GDP and consumption has been created.

It is not merely a linear relationship between consumption and GDP growth, or between export and GDP growth. Nor it is merely a linear relationship between consumption and export. And solely concentrating on boosting any one component, either consumption or export, can hardly sustain the momentum of development forever, especially for a large developing country like China.

### **3.3. China's urban centered export oriented growth**

#### **3.3.1. Domestic consumption power is still not driver of growth**

GDP growth is often used as a major indicator to measure a country's economic growth. Let C

stand for consumption, I stand for investment, G stand for government purchase of goods and services, and (X-M) stand for net export. Then:  $GDP = C + G + I + (X - M)$

To summarize, GDP is influenced by consumption (residential and government purchase), investment, and export.

Table 3. GDP Composition Using Expenditure method (Government of China, 2013)<sup>24</sup>

Year	GDP using Expenditure Method %	Final Consumption Expenditure %	Gross Capital Formation %	Net Export of Goods and Services %
2000	100.0	65.1	22.4	12.5
2001	100.0	50.2	49.9	-0.1
2002	100.0	43.9	48.5	7.6
2003	100.0	35.8	63.2	1.0
2004	100.0	39.5	54.5	6.0
2005	100.0	37.9	39.0	23.1
2006	100.0	40.0	43.9	16.1
2007	100.0	39.2	42.7	18.1
2008	100.0	43.5	47.5	9.0
2009	100.0	45.4	95.2	-40.6
2010	100.0	46.3	65.2	-11.5
2011	100.0	62.8	45.4	-8.2
2012	100.0	56.5	41.8	1.7
2013	100.0	51.0	46.5	2.5
2014	100.0	51.2	46.1	2.7

\*This table is calculated at current prices of each year

The world average contribution rate of final consumption expenditure towards global economic growth remained at 71% -75% for the period of over 50 years from 1960 to 2014, and the overall

<sup>24</sup> This thesis mainly uses data collected between year 2000 to 2014 to support its argument. China's entering WTO in 2001 signifies its complete integrate into the world system and a fully adoption urban-centered EOI strategy. Further, due to resource availability and accessibility, year 2014 is chosen as an end of data presented to maintain consistency.

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consumption rate follows a slightly upward trend. (World Bank, 2016b, 2016c; UNESCAP, 2016) From Table 3, even though consumption constitute a large part of China's GDP growth each year, its overall trend is decreasing and reached lowest 35.8% in 2003. From 2000 to 2014, there are 10 years within this 15 years' interval that have consumption rates that are less than 50%. There are four years in the remaining five years have a consumption rate that is only a little bit over 50%. This is far lower than the world average.

China's average annual consumption growth is lower than its average annual GDP growth. According to the National Bureau of Statistics of China (NBSC, 2015) as well as the UNESCAP (2016), since 2000, China's nominal GDP grew at an average annual rate of 10.37%, while consumption grew by only 8.13%. If bring price factor into consideration, the gap will look even bigger. Yet according to the experiences of most developed countries, consumption growth should synchronize or be slightly higher than GDP growth (Wang, 2006). In most cases, after a country's economy reaches the middle income level, its consumption structure will change at an accelerating speed and its consumption rate will usually rise. Later consumption rate will stabilize at a relatively high level and become the major driving force of economic growth (Wang, 2006).

In 2003, China reached the middle income level of the per capita GDP US\$1000-3000 benchmark that set by the World Bank (2009). From Table 3, it can be observed that since then China's consumption rate has stopped dropping and started to rise. This also falls into the Chenery's model. According to Chenery's multinational analysis on relationship between GDP and consumption (Chenery & Syrquin, 1975), household consumption changes in a dynamic distribution pattern at

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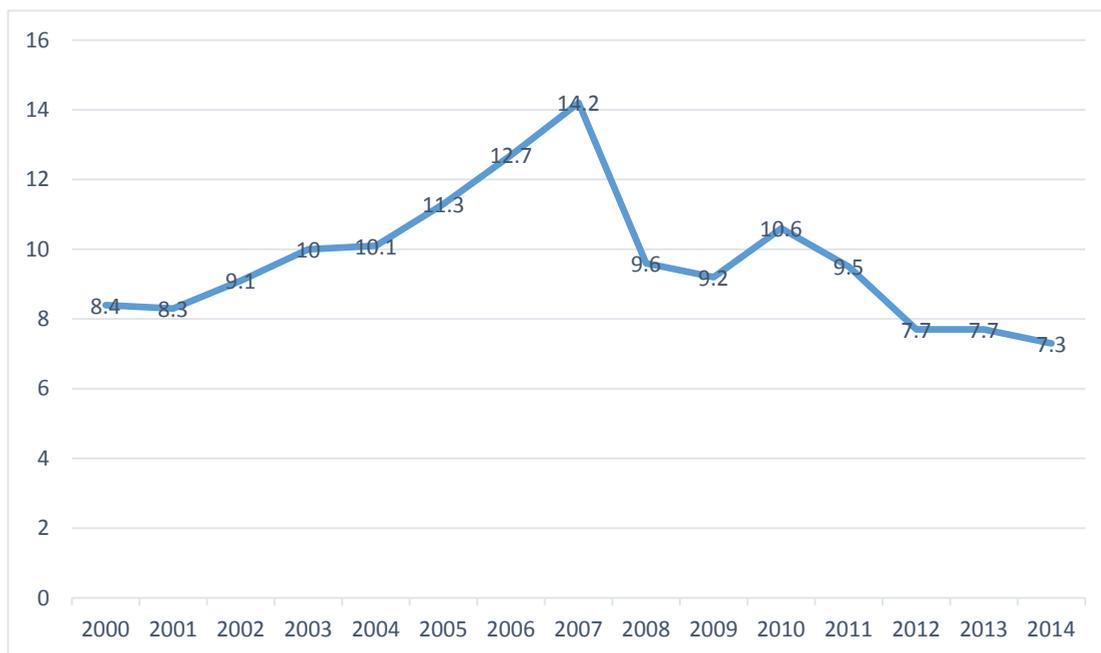
different levels of GDP. For example, use the 1964 U.S. dollar purchase power as a benchmark, when per capita GDP was at a low level of less than US\$100, household consumption is categorized as the basic need consumption type that mainly focus on life necessities such as food and residence. According to study, the consumption rate is very high with the highest reached 77.9% (Chenery & Syrquin, 1975). When per capita GDP rises to nearly US\$1000, household consumption rate start to drop dramatically. Yet when per capita GDP passes the US\$1000 threshold, the household consumption rate started to rise again. But this time, the structure of consumption turned more diverse and aimed to improve life quality thus involves consumptions on education, services, entertainment, and etc. In this perspective, China has great potential to develop its domestic consumption in the future as its economic growth progresses and reaches the high income level.

### **3.3.2. Trade and China's Economic Growth**

Trade has always been a great driving force of fast economic growth in China, though from Table 3, it appears to have a less significant contribution toward growth compare to the other two factors. This is because the contribution of trade towards growth is merely measured by net export volume here, but the development of industries both vertically and horizontally that trade bring about is not showed. Development of trade sector helps increase employment, accelerates development of industries such as transportation and construction, and trigger investment flow. As a matter of fact, a major part of the Gross Capital Formation factor (Table 3) is trade oriented and also stimulated by trade. Many China's coastal cities' economy is largely dependent on trade. These kinds of stimulating effects that trade bring on national economy cannot be ignored.

Figure 3. Average Annual GDP Growth Rate of China (2005 US Dollars; % change per annum)

(UNESCAP, 2016)



It is well recognized that there is a positive correlation between foreign trade and economic growth and it is easy to explain this correlation as well. Since  $GDP = C + G + I + (X - M)$ , when there is an increase in net export ( $X - M$ ), there should be an increase in GDP. This can be seen in China's growth pattern. For example, the year 2003 to 2007, China's GDP growth rate raised from 10% to 14.2% (Figure 3) and the export rate during that period (Table 3) also follow an upward trend. In 2008 and 2009, because of the Great Global Recession, China's export rate has kept dropping which brought GDP growth rate down to 9.6% and 9.2% respectively. And in 2010 China's GDP growth rate bounced back a little to 10.6% while its export rate also raised. Yet there were also periods that export rate and growth rate do not follow this pattern. During the period of 2010 to 2014, China's GDP growth rate dropped from 10.6% to 7.3% while its net export kept expanding its volume. This negative correlation

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puzzled many and had led to questions about how to evaluate the relationship of China's foreign trade and economic growth.

This can be analyzed using the macroeconomic aggregate supply and demand theory (Zhang X. , 2003). When the economy is demand-constrained, that is, there is more domestic supply than demand, export tend to expand faster than import and the net export growth has a significant positive correlation with GDP growth. On the other hand, when the overall economy is supply-constrained, that is, there is more domestic demand than supply, import tend to expand faster than export. Net export has a less significant or even reverse impact on GDP growth. For the case of China, its fast economic development accumulated itself great amount of savings. Its domestic demand has a tendency to expand. This will gradually create a "supply-constrained" situation where export exert less and less effect on growth while demand for import increases. In this case, even there is still net export increase, economic growth tend to fall. Since it is not merely a linear relationship, it is then important to re-exam the relationship between GDP growth and its facilitating factors. Consumption, investment and trade exist independently, but also interrelate and interact with each other. For example, the previously mentioned impetus of import and export to consumption and investment. In order to achieve certain scale of export, there will be investment needs on infrastructure, equipment and etc. And many of such needs have to be met by a significant proportion of imports. According to Zhang (2003), 40% of China's investment needs were transformed into consumer demands for imports this way.

The development of foreign trade has played an important and irreplaceable role since China's

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reform and opening up. China accepted Ricardo's doctrine of comparative advantage and enjoyed the gain from exchange and specialization through effectively exploit its cheap unskilled labor. Export became the driving force of China's economic growth. To expand the scope, export further stimulated investment and consumption growth which through their combined effort pushed China to experience an impressive growth on GDP and national output (Palley T. I., 2011). Yet from the above discussion, it is clear that solely depend on export can hardly sustain the momentum of development forever, especially for a large developing country like China. Although export contributed significantly to China's economic growth, it is just one of the factors. And although it was a relatively powerful factor during a certain period, this period won't last forever.

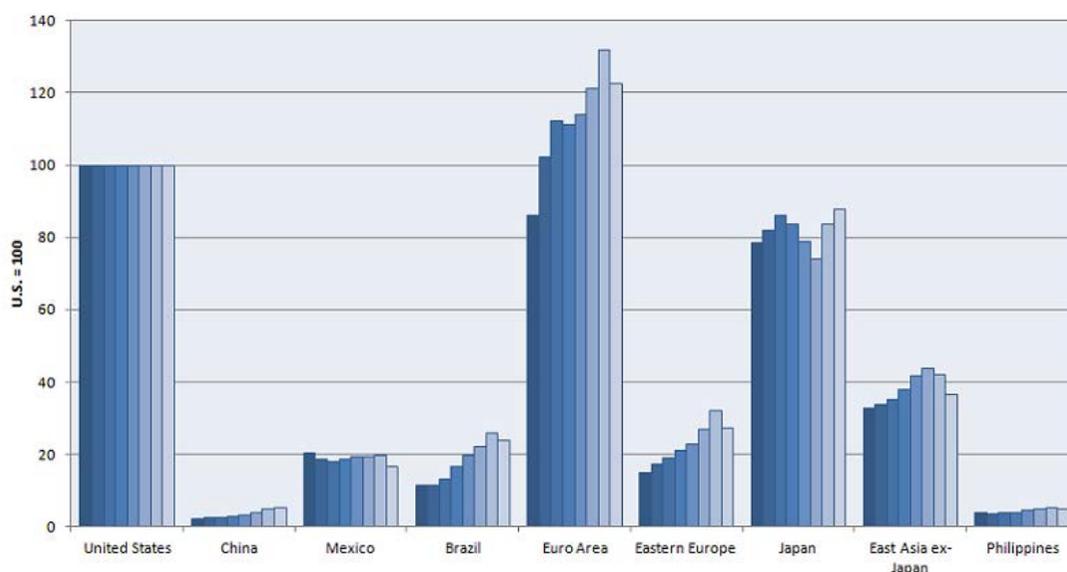
### **3.3.3. Sources of China's urban-centered and export-oriented growth**

China's great economic transition and its tremendous progress on export has been well recognized around the world. Since the reform and opening up, especially since the accession to the WTO, China has made remarkable achievements on economic development. Its total exports has fast catching up and eventually outrun many other developed countries. For example, China's total exports soared from \$ 249.2 billion in year 2000 to \$2.3427 trillion in year 2014. (Chinese Statistic Year Book, 2015) Chinese exports in the proportion of total world exports rose from 3.9% in year 2000 to 12.2% in year 2014; in year 2004 and 2007, China's total exports out run Japan and America; in year 2009, China surpassed Germany and became the world's biggest exporter. (Central Intelligence Agency, 2015)

China's export sector is mainly fueled by a significant amount of industries that require a large labor supply. The most prominent amongst the finished products exported from China are electrical

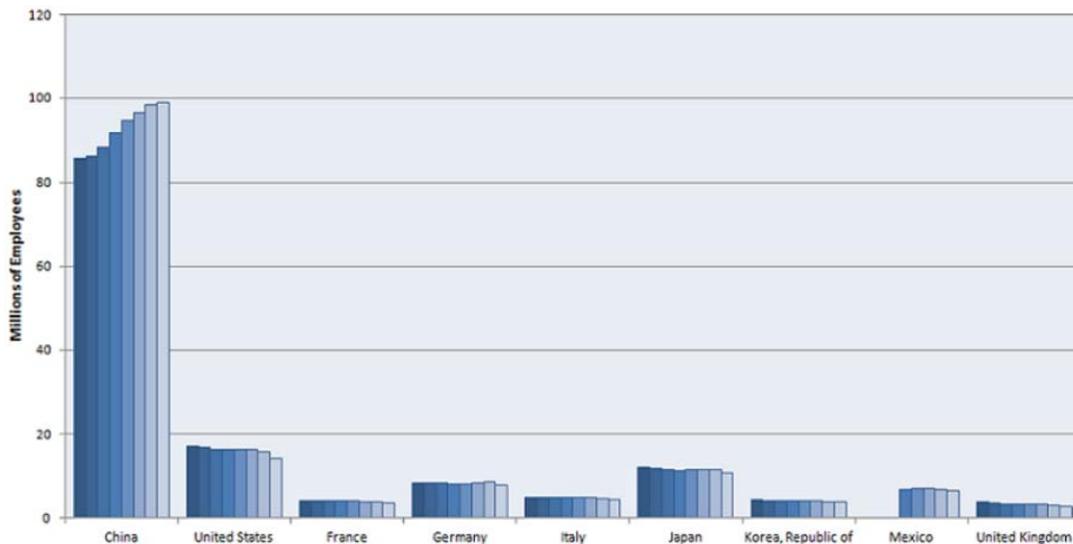
goods, data processing technologies, foot wears, textiles, and optical and medical equipment. China also has the world's biggest new car market (Xu, 2011). China is also exporting a considerable amount of raw materials or primary products like steel, coal, oil, and so on. Lacking technological edge, China depends on wage-competitiveness to keep its booming export sector. Government issues policies that mainly favors urban industrialization. Wage level were intentionally kept down so that “Made in China” maintain its competitiveness in international market (Cao & Zhang, 2015).

Figure 4. Average hourly compensation costs of manufacturing employees, selected economies and regions, 2002-2009



Source: U.S. Bureau of Labor Statistics, International Labor Comparisons.

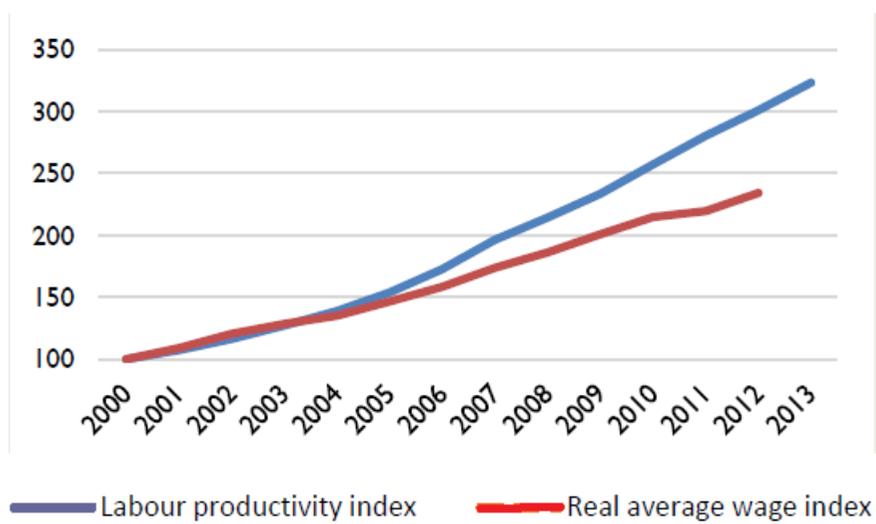
Figure 5. Employees in the manufacturing sector, selected economies, 2002-2009



Source: U.S. Bureau of Labor Statistics, International Labor Comparisons.

Figure 4 and Figure 5 presented an interesting observation on comparing China's labor cost to some other economies. While China employs the most labor within its manufacture sector, its labor cost are among some of the lowest. After four decades of industrialization, average hourly wage in China's manufacturing industry was only about 2-3% of that in the U.S.

Figure 6. China, Labor Productivity vs. Real Wages in Industry, 2000-2013 (Lim, 2014)



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See from Figure 6, the divergence between productivity and wage growth was getting bigger and steeper year by year. Labor productivity has been growing faster than growth in wages. This means more of the productivity growth was going to capital rather than to labor.

### *3.3.3.1. Urban-rural income disparity*

The great success of the export-oriented strategy has generated substantial fund for the entire nation's further development, yet China's income distribution has become increasingly unequal since reforms started in 1978. The Gini coefficient (a common measure of income inequality), a low 0.288 in 1981, reached 0.388 in 1995, and reached highest 0.491 in 2008.<sup>25</sup> Such dramatic change is highly unusual. It is obviously necessary to have a rethinking on the structure of distribution of incomes.

Rural-urban differences in China have always constitute a large share of unequal income distribution.<sup>26</sup> It is well rooted in the institutional legacies of socialism before the reform. Urban and rural residents are separated through a strictly enforced household registration (Hukou) system thus hindered the mobility of residents. Absent the need of job searching, urban workers were assigned to different work post for lifetime. Health care, housing, and pension benefits are also provided. In the rural area, residents also have access to basic health care and education. They worked collectively in the form of commune. The government set urban and industrial development as the main object of economic planning thus agricultural was no longer the focus of policy. On top of diminishing rural investment that was directed to subsidize rapid industrialization, the government, by keeping the price

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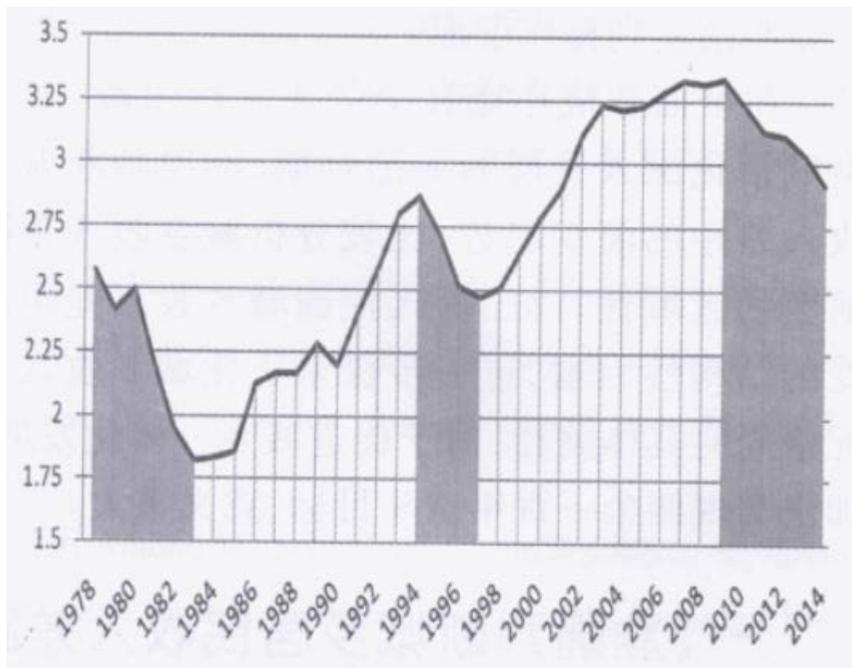
<sup>25</sup> See appendix 1.

<sup>26</sup> Changes in rural-urban inequality accounted for 47.4 percent of the increase in inequality between 1985 and 1995, contributing more to inequality than interprovincial, intra-rural, or intra-urban inequality. (Atinc, 2010)

of agriculture products low, took a fraction of rural income to fuel the urban industrialization, leading to sharp differences in the living standards of urban and rural residents. All these add to the wage differences that urban income is 2.5 times higher than rural (Tian, 2010).

Figure 7 showed the trend of China's urban-rural income gap from 1978 to 2014. Since 1978, the reform started in the rural areas with the implementation of the contract responsibility system. Labor initiative that suppressed under the old system was quickly released, along with rural labor productivity. Income level of rural residents has increased substantially. The income gap between urban and rural residents narrowed.

Figure 7. China's urban - rural real income ratio (Lu & Zhu, 2015)



As the reform moved forward, starting 1983, the narrowing gap of urban-rural income started to

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widen again. Government policies' focus of development shifted from rural to urban areas and from the agricultural sector to the industrial sector. Industrial development was faster than agriculture development and urban residents benefited from this significantly. Income of urban residents increased rapidly. Meanwhile, in the rural areas since the household contract responsibility system has been established, income level tend to stabilize and not moving up too fast. There is not too much room for the rural economy to make any further fast progress in a short term. Further, government's support and investments toward agriculture were shifting away year by year. These all added up to the re-widening urban-rural income gap.

Policies biased against the rural areas has kept causing the continuous widening of urban-rural gap and brought a "price scissor" effect on agriculture product, land, finance, and wage. There are four categories of "price scissor". First, the "price scissor" on agriculture. On October 16<sup>th</sup> 1953, the CPC Political Bureau of Central Committee adopted the *CPC Central Committee resolution on the planned purchase and supply of agriculture product*. The State Council issued relevant orders and enforcement measures to mandatorily allow the state to purchase agriculture products (mainly grain) at a price that is lower than its actual value. And peasants were to purchase industrial products at prices that were higher than their actual value, hence the "price scissor" on agricultural products. Around 132 kind of agriculture products, for example, grains, eggs, pigs, tobacco, silk products etc., were not allowed for free trade, and could only be traded at a price set by the state at designated venue. According to some scholar's calculation, from 1950 to 1978 (before the reform), 510 billion yuan, equal approximately to nowadays 49 trillion yuan, were taken this way from rural. And from 1979 to 1994 (since the reform

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and opening up), an altogether of 1,500 billion yuan was extracted this way, equal to 93.75 billion yuan per year (Chen & Wang, 2013).

Second, the “price scissor” on land, which means the state deprives the peasants’ proper rights of land through coercive administrative means during the process of land requisition. Peasants’ land interests cannot be fully compensated compare to if otherwise operated under the principle of market economy. China’s urbanization and industrialization process have improved urban residents’ living standard and wealth, but left the rural peasants behind. Some even believe that the rural areas and peasants are the victims of urbanization caused by land acquisition. (Shi, 2012) From 1978 to 2001, China moved fast forward with its urbanization process. The state has accumulated at least 2 trillion yuan of funds through “price scissor” policies on land. (Chen & Wang, 2013)

Third, the “price scissor” on finance. On finance and investment, the state still implement a non-balanced development strategy favoring the city. During the 90s, only 46% of rural savings financed the rural sector, while 54% of rural savings were channeled to urban. By the end of 2008, the balance of savings of rural residents was 5.25 trillion yuan, while loans from financial institutions to agriculture and township and village enterprises were 2.5 trillion yuan. The more than 60% of the national population only used up 6% of the country’s total loan. (Chen & Wang, 2013) Industrialization demands long term and continuing commitment of capital inflow. This determines the development of rural areas will be left behind for a long period of time.

The dual financing pattern of rural and urban created many folds of disparities on, for example, education and welfare etc. Each every one of these disparities worth in-depth researches of their own.

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Education services received by urban and rural residence are unequal. At present, the average number of years of education at the county level (including the county level) is 6.33 years for rural residents, while that of the urban residents is 8.68 years. Only 0.3% of the rural population have tertiary education, compare to 7.97% for urban. Among college students, 70% of them are from urban and 30% are from rural. This put such a contrast on 60% of the total population are rural originated and 40% are from urban. The high school completion rate of rural areas is 4.87% compare to 22.17% from urban areas. The population with illiteracy<sup>27</sup> is as high as 64.1% in rural areas compare to 34.9% in urban areas. (NBSC, 2015) The current rural-urban difference in education hindered the speed of rural modernization, affected the rural ability to accept advanced agricultural technology and hindered the popularization of science and technology in rural areas. It added to the difficulties in transforming science and technology into practical productivity and eventually affect the growth of rural income and rural development. China's social security and welfare system also differed between rural and urban. The urban social security system is more complete than rural. Compare to urban, rural social security system failed to provide social securities on, for example, unemployment, work related injury, maternity, and so on. On top of this, social insurance spending differs greatly for urban and rural as well. Urban per capita social security expenditure is much higher than rural. According to Chen (2013), urban per capita social security expenditure is more than 90 times in rural areas.

Fourth, the "price scissor" on wage. Starting 1992 with the 12th National Congress' further decision to extend market economy from the agricultural sector to the whole economy, China began

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<sup>27</sup> Illiteracy here defined as those who have not attended any kind of school, or those who do not finish junior high education.

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embracing an export-oriented development reform. Policies were directed to encourage private enterprises and foreign investments. China, with its vast size with abundant resources as well as cheap labor supply, attracted great amount of investments to flow in. The huge labor supply ensured China to exploit the comparative advantages on lower cost hence Chinese products were competitive in the international market. Entering the new millennium, China joined the WTO in 2001 represent a more thorough integration into the world system and made China play its comparative advantage to the full. Higher wage attracted migrants from the rural areas to the urban areas where hosts many rapid developing industries such like export processing and construction. Migrant workers left their home to the cities in seek of better earnings in order to support the elderly and young that were left behind. Their working income are the major source of the whole family. According to the National Bureau of Statistics (NBSC, 2015), the total number of migrant workers in 2015 is 277.47 million, an increase of 3.52 million over its previous year, which is an increase of 1.3%. Yet there is a large wage gap between migrant workers and urban workers due to their different education level, labor skills, and welfare background. From 2001 to 2005, the annual average wage of urban workers in China increased by 69.3%, that is an average annual growth rate of 14.1%; while the annual average wage of migrant workers increased by only 19.5%, an average annual growth rate of 6.3% (Chen & Wang, 2013). By 2008, the overall income level of urban worker is higher than rural worker annually by 31.6%, monthly by 11.9%, and hourly by 26.2%.<sup>28</sup> (Tian, 2010) The largest annual income gap between the two groups confirmed the urban workers enjoy better pay as well as welfare support than migrant workers.

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<sup>28</sup> Income include the sum of paid wage and social welfare.

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Monthly wage gap is smaller compare to hourly wage gap. It shows that migrant workers are working longer time in order to obtain more income.

### *3.3.3.2. China's efforts to ease current problems*

China's declining wage share was accompanied by fall in private consumption.<sup>29</sup> This is because on the macroeconomic level, wages are not simply a cost factor, but it is also a source of aggregate demand. This in turn aid to China's dependency on foreign market for earning income. In order to sustain growth despite stagnating or declining wage share in national income, China have to keep encouraging export to generate net export surplus to externalize and overcome the domestic demand shortage problem. Strategies that favor export-orientation in turn trigger the suppression of domestic wage. Yet the global market's demand and financing patterns are unsustainable. When crisis like the 2008 world economy crash and the accompanying Great Recession happen, a global demand shortness is an overarching structural condition that rendered the Chinese economy confronts a troubling outlook of significant demand shortage (Xu, 2011).

In light of the consequences of the export-oriented growth strategy such as resource intensity and income inequality, as well as reflections on the global financial crisis, rural-urban disparities on wage has gained considerable attention and called for the need of policy alterations. Many Chinese provinces and cities started to raise their minimum wages.<sup>30</sup> Government started to subsidize rural

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<sup>29</sup> See Table 1.

<sup>30</sup> See, for example, report on the wage adjustment in Guangdong and Shanghai in 2010 (<http://www.clb.org.hk/content/wages-and-employment>); report on nine other provinces and cities, including Beijing, who adjusted the minimum wage ([http://news.21so.com/2016/hongguan\\_812/1421840.html](http://news.21so.com/2016/hongguan_812/1421840.html)).

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and agriculture by providing favored purchase prices, lower or even eliminate agriculture taxes, and invest in rural infrastructures etc. For example, there are the establishment of “Grain Fund” in 2004 in order to subsidize peasants who grow grains for a living; subsidies on purchase of agriculture machineries; subsidies on seed and fertilizer purchase etc.<sup>31</sup>

These measure did bring about visible improvement on narrowing the urban-rural income gap. Because many policies that subsidizing agriculture are implemented since the year 2004, the widening speed of urban-rural income gap decelerated a lot compare to the previous years (Figure 7). And since 2010, the gap reached its turning point and start to narrow again. Up until 2014, urban per capita real disposable income is 28,844 yuan, an increase of 9.0% compare to 2013; and rural per capita real disposable income is 9892 yuan, an increase of 11.2% compare to 2013. (NBSC, 2015) And the national income ratio of urban and rural now drops to 2.92: 1 (Figure 7).

### **3.4. Further problems**

Only subsidizing agriculture and peasants is far from enough to bring a thorough close of the urban-rural gap in any foreseeable future. The measures themselves also tend to exhaust their means on further the cause.

Wages have certainly increased over the last decade but so has the cost of living.<sup>32</sup> Further, increase of minimum wage have slowed considerably since 2012 (Chen & Wang, 2013), and in 2016, Guangdong announced that it would freeze its minimum wage for the next two years. Current central

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<sup>31</sup> See related news report: China’s agriculture subsidy overview: <http://www.tuliu.com/read-25500.html>.

<sup>32</sup> See from the various years of China Statistic Year Book for price index comparison of major merchandises.

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government policy was clearly stated by Vice Minister for Human Relations and Social Security, Xin Changxing in July 2016 that because: “Our advantage in labor costs is no longer as clear-cut as before; we should ease the frequency and scale of wage increases so as to preserve our competitive advantage.” (China Labour Bulletin, 2016) The pressing concerns lay not with how to subsidize those who were underpaid, but to alter the entire structure of urban centered export-oriented strategy that predicate on wage suppress.

The urban-rural divide also appears in differentiated accessibilities to healthcare, education, cultural and social services. While urban residents who live in the cities have reasonable unfettered access to such services, rural residents will have to pay so much extra in order to travel and stay in the city that provides the services. Even though some smaller and medium-sized cities have begun to relax their administrative barriers to rural migration which made these cities a more viable option for migrant workers, there are no signs that major cities like Beijing, Shanghai and Guangzhou will too (China Labour Bulletin, 2016).

According to Cao and Zhang’s model (2015), every one percent level increase of urbanization widens the urban and rural income gap by 0.3731 percent; and one percent level increase of industrialization widens the urban and rural income gap by 0.9152 percent. Industrialization and urbanization has been the core of China’s development strategy. As the process of urbanization continues and industrialization deepens, in a certain period of time, urban and rural income gap will continue to expand. That is because, first of all, industrialization will keep absorbing most of the investments and skilled workers. Second, the process of urbanization will continually pushing

resources and production factors to urban. Third, one character of urbanization is a continuing expanding urban boarder. Geographical constitution of where is urban and rural thus continuously changes. With urban expand its boarders, once was rural become urban, and once those who categorized as rural residents may be re-categorized as urban residents. These new urban areas are often more developed in itself and its residents often have a higher income levels than other more remote located rural areas. With the continuous extension of urban boarders, the rural high-income areas and population are continually stripped away, making the overall rural income level decrease, thus naturally lead to continued expansion of urban and rural income gap. Currently speaking, both urbanization and industrialization will likely continue their influence until entering a comparatively stable stage.

The current development consequences are an interaction of political, economic and social forces that require careful evaluation. A strategy focus shift and structural change in the system itself will influence the bargaining power of labor versus capital over how income is distributed. After reviewing the data in the foregoing pages, we will now turn to the discussion and conclusion chapter on further understanding of the consequences of China's urban centered export-oriented industrialization.

## Chapter 4. Discussion and Conclusion

### **4.1. Summary of findings**

After the collapse of the USSR, Chinese leaders recognized that their models were neither lasting nor universal. The socialist model of a centrally planned economy would not work for China. Even though the adoption of the model has made the society more egalitarian and improved equal distribution, it was only a society where everyone became equally poor. China then turned to a market economic reform in 1978 which has dramatically changed its economy. At the meantime, as China has adopted a reform paradigm that focused on boosting growth through extracting resources from rural to fuel urban and export development, many problems emerged. Among which, the most significant one is an extremely weak domestic market to back up China's huge production capacity when it is facing an international demand shortage. The 2008 global economic crisis and recession had rang a toll on the necessity to make imminent changes.

#### **4.1.1. The issue of inequality**

During the reform period, China's fast rate of economic growth, which in most years reached, or almost reached, double digit levels, filled the rest of the world with astonishment. However, accompanying this, is the rising income inequality between rural and urban. This rooted in the policy focus of China's urban centered export-oriented industrialization strategy. Inequality was believed to

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be an acceptable and an unavoidable stage to achieve growth and reduce poverty. The notion is, with industrialization and growth, income inequality would initially rise and fall thereafter. Yet actually, after four decades of rapid growth and industrialization, the trickle-down effect did not happen. On the contrary, income inequality, though lowered initially and occasionally during the reform, has kept deepening its scope and painfully exposed China's vulnerability to the recent global financial crisis.

The income inequality in China is primarily driven by the rural-urban difference, which can be characterized as "urban bias". Urban incomes are raised and protected and urban areas receive priority over rural on public spending on infrastructure and service improvement. Further, it is argued that urban residents possess disproportionate political power and influence that further biased government policies to aid to their interest (Lipton, 1977). The high growth has not been shared equally by its entire population.

As discussed in the previous chapter, the Chinese economy is still predominantly rural. Ideally, policy targeting rural areas would bring a more sustainable development. Indeed, many initial measures of the reform in rural China resulted in rapid rural production and income increase. However, when later the reform eventually extended to the whole economy and policy focus shifted to urban areas, the large rural population was denied an equal share of benefit resulted in fast economic growth. Further, on top of diminishing rural investment, the government, by keeping the price of agriculture products low, took a fraction of rural income to fuel the urban industrialization.

Rural-urban income difference attracted large migration of workers from rural to urban areas. They usually work longer compare to their local urban counterparts. Yet due to the household registry

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Hukou system, they are restricted from enjoying equal local welfare. And they are met with lower wages and discriminating regulations on accessing social benefits. Migration, though large in scale, only exist in the form of “floating” population. This drove down the labor cost and attracted export focusing FDIs which further aided to export-oriented industrialization.

Inequality, both in terms of income distribution as well as unequal access to opportunities like education, health, and technology, has worsened for China, particularly the rural Chinese. It is now one of the most pressing problems for China, with serious political and social consequences. The urges to address this issue has never been so high since the growth process should not ignore any group of people, particularly of those who are disadvantaged.

#### **4.1.2. China’s export and growth**

Date early back to Adam Smith, export is argued to be able to positively affect growth. It finances import, attracts foreign investment, brings innovation and provide employments. Moreover, export is also very helpful on absorbing surplus resources, labor and productivity in the economy since trade will provide effective demand (Awokuse, 2003). Therefore exports help promote growth not only by generating income but also by its transmitting effect that reflected in imports, investment and labor input (Fu, 2004).

In the years following the market reforms, dismantling the old planed system left China a substantial surplus of productivity capacity as well as labor supply. Further, these surpluses’ creation is also due to reasons such as, over-investment in export-oriented industry, policy and structural distortions, unequal share of income, consumption growth stagnation, etc. Export provided effective

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demand not only for this surplus capacity, but also for China's surplus labor (Fu, 2004). Hence export would be able to tremendously boosted economic growth. After high-speed growth over nearly four decades, China has emerged as the "world factory". It became a major exporter in the world market in textiles, footwear, light engineering and so on. China is also exporting a considerable amount of raw materials or primary products like steel, coal, oil, and so on. Moreover, frequently with the help of multinationals from industrial countries through knowledge share and technological co-operations, China have also demonstrated its capability in high value-added areas of electronics, telecommunications and machinery (Yin, 2002). China's export-oriented growth is driven heavily on foreign demand and investment with much of that investment concentrated in manufacturing thus contributed to tradable sector's expansion. When an economy based its long-term growth perspective on the growth of export-oriented industrialization strategy that predicate on price competitiveness, it tend to issue policies to subsidize all input costs for export production. Exports and export related investments were promoted by significant cost advantages from the lower cost of energy, utilities (including water), capital (a substantial undervaluation of the exchange rate), land, and pollution by not having sufficient environmental laws and regulations as well as proper enforcement process. Incomes were channeled on favorable terms to invest in manufacture and further expanding the export industry instead of been passed back to people to stimulate consumption. Further, at the local level, production based value-added tax has given local official incentives to develop policies that favor industry over service sector (Chen & Wang, 2013). Service sector improvement is hindered from policy bias against private ownership.

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The overall subsidization of input costs to continuing the path on export-oriented industrialization strategy is almost certainly unsustainable since it encourages non-economic and non-sustainable use of energy and resources. Environmental problems tend to intensify as well. Further, the national economy that is likely to face global fluctuations. Clearly the international economic conditions nowadays are very different from before when China just embarked on export-oriented growth. Back then it could heavily rely on the foreign market (particularly the U.S.) to provide demand for its exports. Yet in light of worldwide growth stagnation and demand shortage after the economic recession since 2008, China will confront severe difficulties if it keeps relying on its international export market.

The export-oriented industrialization strategy which relies overly on lower cost and cheap human capital input hindered the overall improvement of human capital of the society thus prevented further social development and stuck China in its current economic and technological stage. The desire to lower costs to improve export competitiveness discouraged domestic investments in human capital improvement such as education, health and general social welfare. Those worst affected are likely to be unskilled and low-skilled workers who had already been the disadvantaged groups of the society. They tend to be the first to get laid-off during any economic slowdown and/or at any time when enterprises decide to cut off redundancies for logistic optimization. It is also difficult to have them reemployed in a short period. And social welfare system is inadequate in providing proper support during such transition. Social instability and poverty will be easily created. Thus repressing investment on human capital can easily prevent the entire society from reaching higher level of development. Further, slowdown or even stagnant improvement on human capital will result in weak innovation

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abilities for industries to upgrade. It seriously prevented appearance of high-tech industries thus stuck China in the lower value-added chain of supply. In order to keep its products' competitiveness in the international market, China will then have to keep pounding on its domestic resources and depriving its worker of better welfare to lower the cost for export. A vicious circulation is created. China is in need of an imminent economic transformation.

Export allowed China to access international markets and funds and this helped surging economic growth initially. But it is a more difficult task to sustain it. As also discussed in the previous chapter, pinning a nation's growth hope solely on export is unwise. Export should not be deemed as the only source of growth. Nor is its only purpose to merely generate income. Export activities will always exist in an economy regardless whether it takes up an inward or outward development strategy, as export is an useful instrument that serves to promote technology advance and innovation, to vent extra production and labor capacity, and to improve competitiveness of domestic industries. The true evaluation criteria for success development should be measured by the well-being of a nation's entire population instead of merely measured by the macroeconomic growth.

As also mentioned in previous chapters, it is the transmitting mechanism among import-export trade, investment, and consumption rather than export itself that affect growth. For example, export revenues used for imports of capital-intensive goods that could not be produced domestically (due to lack of know-how or capital etc.) which made imports actively helping upgrading the economy in both the export and domestic sectors, thus furthering domestic living standard. At the meantime, domestic investment and consumption can also be stimulated accordingly. In this perspective, a healthy

economy depends on a healthy operation of all the factors in combine. China should shift its policy focus from exports-orientation to a more balanced development strategy.

How dependent is an economy on export is determined by several factors including trade structure, trade policy, scale of economy, and the stage of economic development. For example, comparing to large and advanced economies, small and underdeveloped economies tend to have a higher dependency on export since it is under the pressure to earn sufficient income that could not be enough generated domestically. Further, small and underdeveloped economies are also more affected by shocks from external markets and external funds.

Countries in different stages of economic development may also varies on their dependency on export. Countries in a lower stage of economic development and industrialization normally do not have extensive foreign economic relations thus they also tend to have a low export dependency. Countries in an intermediate stage of economic development and industrialization generally have heavy industries as focus of economy. This type of economy need large sum of raw materials and fuels that have to be imported mostly. In order to balance imports, scale of exports is also like to be expanded thus these countries tend to have a higher dependency on export compare to when it was in the lower stage. Countries in an advanced stage of economic development and industrialization generally focus their core competitiveness on technology advance and innovation. Industrial structure is technology-intensive and countries gain income through output of capital, technology and management know-hows. As a result, export dependency of these countries are moderate or low. China is currently in the intermediate stage of economic development that highly dependent on export

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fueling its industrialization. In order to move up to the advanced stage of economic development and industrialization, China should shift its focus from export toward a more balanced innovation-driven development strategy by measures such as: move up the value-added chain by encouraging high-tech industries' development, export of more sophisticated products, and bring in new industries to diversify exports etc.

#### **4.1.3. China's consumption and growth**

Under neo-classical economics theories, wages are determined by marginal productivity, (Lim, 2014) which means wage increase should generally be paralleled with labor productivity growth, though there may be occasional divergence. However, in China, wages have consistently lagged behind productivity growth most of the time due to national policies and/or global forces. Over the years, technology advancement and the global trend of removing political and economic barriers in trade and capital flow has put great pressures on labor bargaining power over income distribution both in the rich and poorer countries (Palley T. I., 2006). It was believed that globalization will bring income increase for labors of less developed countries. On the contrary, many less developed countries actually took up policies that repressed welfare and wages to reduce production cost in order to attract foreign investments. Because capital moves faster than labor, globalization has continually putting downward pressure on wages (Palley T. I., 2006).

Over the past decades, because of globalization, an international production network, or sometimes termed as global supply chain (GSC), appeared where many countries participating in the production of a single product. Different countries occupy different stages of production according to

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their own level of economic productivity development. Each country imports inputs to process and then export either as finished product or as intermediate goods for further value addition in another country. This process does not benefit all countries equally. Countries producing high value-add intermediate or finished products get the most benefit, while those who producing low value-add products using cheap labor benefit less. This of course affected each countries' wage share and income distribution differently according where their occupation in the value-add chain (Lim, 2014). China, due to lack of technological edge, is at the lower end of the value-add chain that bases its competitiveness on lowering unit labor cost. The mostly affected were the rural population that account for more than 60% of the entire population. Thus there is only moderate consumption growth due to limited income increase of the majority of the population is under-paid. Domestic demand is suppressed which in turn made the economy automatically over-dependent on exports. Further, the dependence increased even more significantly after China's entry to the WTO in 2001.

In recent years, partly due to China's one-child policy<sup>33</sup>, the supply of rural labor has been gradually diminishing. Hence work slightly to enhance labor's bargaining power of wage. Further, government at both central and local level start to address the urban-rural difference issue by allocating considerable amount of funds into subsidizing rural and agriculture development; there are also related policies that aiming at subsidize agriculture activities. This helped narrowing the urban-rural income gap to a certain extent and alleviated some domestic tensions (Tian, 2010). Yet these are far from enough to bring a thorough close on the urban-rural income gap to fundamentally increase

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<sup>33</sup> Since 2016, the Chinese government has abolished the one-child policy. Yet for its effect to really take place still requires significant amount of time.

the domestic consumption level and rebalance the social economic development. To fundamentally increase consumption level means a fundamental rise of income while mitigating the urban-rural income differences by focus on those who were disadvantaged in the past. Policies should include, for example, better accessibility to public health care for the poorer, universal accessibility to education services, more fiscal revenue devoted to the provision of public goods rather than to reinvest, mitigating domestic inflation and real-estate prices to lift constraint on consumption, and continuing support and investment in rural development.

For the improvement of China's export sector, it can continually optimizing its export production structure by moving up the value-add chain through developing industries that are more environmentally sustainable, energy efficient, and high technology. But at the same time, China have to reduce its dependency on foreign market by reducing the need for gaining more market share; and redirect certain productive capacity to serve internal market. This means a restructure of tradable sectors as well as building new productive capacity in sectors that serve local consumers (Palley T. I., 2011; Lim, 2014).

China need to rebalance its economy by shifting focus from an export-oriented growth to a new paradigm of domestic demand-oriented growth that characterized by focusing on building a healthier rural economic environment for the rural residence. Wage suppression for securing cheap labor advantage in export markets contradict to economic growth to raise living standards, which means higher wages and higher domestic consumption. Under export-oriented growth, higher wages undermine growth. Under domestic demand-oriented growth, they support it.

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## 4.2. What remains in question

This thesis focuses on examining China's urban centered export-oriented industrialization strategy and its consequence of weak domestic market demand caused by the asymmetric urban-rural income allocation. A few related points can be extracted for other related research.

Firstly, there is a significant difference between export as part of growth and export-oriented growth. For any open economy, export is a necessary part of growth to earn foreign exchange to import goods and services. However, when a country takes up export-oriented growth strategy, it deems export as a driver of growth. It explicitly builds its industrial and/or trade policy to promote exports. Such policies include, for example, repressing wages and curtailing welfare<sup>34</sup> to keep costs low, designing monetary and tax policies encourage businesses to export, as in China. Export-oriented strategy tend to lead to inadequate domestic welfare, and stagnation of human capital improvement. Competitive advantages based on lowering the cost mainly benefited foreign consumers who get to purchase goods at a lower price at the expense of domestic consumers. At the meantime, domestic consumers are also facing higher price of import goods and services (Lim, 2014). It is thus worthwhile for future researches to exam the extent to when does export as part of growth start to transform into export-oriented growth.

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<sup>34</sup> For example, China prohibit voluntary trade unions. The only legally mandated trade union, the All-China Federation of Trade Unions (ACFTU) has a titular presence in many workplaces. The union representatives are largely under the sway of management and have no real connection to ordinary workers. Trade union officials currently have neither the will nor the ability to effectively represent their members in wage negotiations with management. In many cases, they will actually side with management against the workers. (China Labour Bulletin, 2016)

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Secondly, while the sustainability of China's current growth patterns has caused concerns from a domestic perspective, there exists an even larger issue from the perspective of the whole world economy where many other developing countries who may also pursuing the same strategy. Palley (2003) used the phrase "crow-out" to describe what would happen when a group of countries all based their economic growth on expanding exports to industrialized countries. Due to limited international demand growth, competition will be getting ever fierce. It narrows the maneuvering room of latecomers and exerts a certain "crowding-out effect" (Palley T. I., 2003). Those who want to keep going has to compete with each other on who can offer the cheapest price. This eventually become a destructive competition on wage, environment and social standards suppression that undermines development of standards, institutions, and wage growth. This certainly has its implications for both China and countries attempting to follow China's pattern of development and worth further research attention.

Thirdly, the fast progress of urbanization presented potential opportunities to further growth. The speed of urbanization in China is tremendous thanks to migration from the countryside that expanded the urban population. Even though rural population still consist of the majority of the population, judging from the increasing speed of urban population growth, it is reasonable to assume the urban population would exceed that of rural in the near future. Further, judging from the development patterns of other countries, urbanization is happening around the world and is inevitable due to technological advances and population increase. The convenience of goods and services is one of the benefits of urbanization. Urbanization process allow increased literacy and better health since cities

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provide easier and better access to advanced educational and medical services. There is possibilities of better social integration in urbanized areas. People of different religions, ethnic backgrounds, social classes and races reside in the same area. This leads to more understanding and acceptance of differences. On the other hand, it should be also taken into consideration some potential problems related to urbanization such as pollution, growing unemployment due to intensified competition and so on (Henderson, 2009). International experience demonstrates that cities are the focal point of technology, information and services. The rapid urbanization provide China with enormous opportunities to maintain high growth through various potentials. For example, increased domestic demand compare to export demand as median or small sized cities accelerate their growth; better efficiency in investment as well as utilizing existing resources; and technology advance that could aid to growth of high value-add manufacturing and services. The key is to substantially reform urban policies and institutions while further integrate the urban and rural sectors to achieve harmony.

Another point worth noticing is the demographic reality of China. China's 2010 census documented some profound demographic changes. The new census data confirmed and revealed that China has entered a new demographic era, featured by prolonged low fertility, rapid aging, massive urbanization and major geographic redistribution (Cai, 2013). These new changes corresponded with China's economic prosperity as well as increasing inequality. Under a broader context of ever fierce global competition, there changes certainly would have profound effect on China's future direction of economic development as well as the world social and economic development. Among all the challenges, fertility decline is the cause of all other challenges such as rapid aging and labor shortages.

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With the shrinking of working population and the expanding number of elderly Chinese, China need to seek out alternative growth patterns for more sustained development since labor cost is almost certain to increase, not to mention associated increase of social cost (Cai, 2013). The elimination of “one child policy” in 2016 signals one of the steps that China respond to these demographic challenges. Further research on this subject will definitely be valuable.

Last but not least, the question “what will be an appropriate development model for China” has been among the most frequently asked questions. As still a developing country, China remains in the relatively low level of economic and social development and facing with many difficulties and challenges in the realization of poverty reduction and common prosperity. Of course the government is taking various measures trying to resolve them. And China has made great progress on catching-up and establishing a strong industrial economy over four-decade reform development. During this time, China has also made many breakthroughs in exploring its own development paradigm. At present, China seems to be moving in multiple directions at the same time, with no discernible pattern. That is, China is still in search for a development model, based on the concept of balancing growth distribution to achieve better social development. The findings of this thesis confirm that the urban centered EOI strategy indeed alleviated poverty to certain extend and has also helped resolve a series of social problems and contributed to some social improvement as well. However, in order to sustain economic growth and achieve more balanced social development, it is necessary for the government start shifting focuses and introducing new measure of reforms that would fundamentally change the productive and distributive structures of the market and society. Time should be devoted to study what

development model it will be in the end.

This thesis does not try to generalize the findings, nor does it try to extrapolate future implications. This thesis only serves to explain the major problem created by China's current development focus which is the domestic demand shortage caused by urban-rural distribution differences. The finding is that current pattern of development that served its purpose in the past has become unfit for addressing further growth and social development need. Even so, the scope of the paper presented is limited and more research must be done to study China's development strategies.

#### **4.3. Conclusion**

Inequality has been rising since China's economic reform. This thesis emphasis on analyzing inequality in terms of urban-rural income differences that induced by the combination work of global forces and national policies particularly the urban centered export-oriented growth model pursued by China.

Since the market reform, the impressive growth rate has accompanied by increasing inequality and declining wage share of national income. This is because both global forces and government policies put a downward pressure on labor's bargaining power of income. It resulted wage rising slower than productivity. Since China is on the intermediate development stage and occupying the lower position on the global supply chain, it pursued an export-oriented industrialization growth model based on inviting foreign direct investments into labor-intensive industries. This means wages need to be always repressed in order for China to maintain its international competitiveness. Thus many policies are issued in this regard. Labor activities are repressed, social welfare declined. Since the majority

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labor supply of China are migrant rural worker whose share of income and welfare were the mostly undermined, declining wage share leads to falling private consumption and aggregate demand.

China was also overly dependent on international market for its exports thus made it more vulnerable to external conditions. After the recent global financial crisis, the current shape of international economic environment does not resemble its past. China's export-oriented growth is facing declining global demand and ever intense competition from other competitors. The ever growing of social and environmental cost has also made it more difficult to sustain an export-oriented strategy that predicate on cost. It is unlikely that China can continuously depending on exports as the main driver of growth.

The urban-centered policy focus has created severe imbalance. The majority rural population did not have an equal share, compared to the urban population, of income, accessibility to health, education, culture and social services and etc. This is certainly will not sustain and eventually undermine the whole society's welfare improvement. For the purpose of both seeking new source of growth as well as to achieve a more balanced growth, China should turn from international market to domestic market demand.

To achieve this, first, China need to restructure its production structure. Since oversea demands and domestic needs won't match exactly, the production capacity for export cannot be used to meet domestic needs. Second, China also need to restructure its distributive and redistributive regimes. Wage growth should keep up with productivity growth in order to rebalance the labor and capital share of GDP. This will make sure more gains could be used to fuel domestic consumption instead of captured

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by capital in the form of higher profits or by external consumers in the form of lower prices. Thirds, increasing wage share for the majority population by focusing on building a healthier rural economic environment for the rural residence. Government and private reinvestment should focus on rural development while avoiding over investment on the export sector. Government policies should also encourage more generous wage and stronger social safety nets.

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 Appendix 1. Urban and rural income inequality, 1978–2011(Gini coefficients)

Year	Rural	Urban	National	National with adjustment
1978	0.212	0.16	n.a.	n.a.
1979	0.237	0.16	n.a.	n.a.
1980	0.238	0.16	n.a.	n.a.
1981	0.239	0.15	0.310	0.280
1982	0.232	0.15	0.285	0.259
1983	0.246	0.15	0.283	0.260
1984	0.258	0.16	0.291	0.269
1985	0.264	0.19	0.290	0.265
1986	0.288	0.19	0.324	0.292
1987	0.292	0.20	0.324	0.289
1988	0.301	0.23	0.330	0.295
1989	0.300	0.23	0.352	0.318
1990	0.31	0.23	0.349	0.316
1991	0.307	0.24	0.371	0.331
1992	0.313	0.25	0.390	0.342
1993	0.329	0.27	0.420	0.367
1994	0.321	0.30	0.433	0.376
1995	0.342	0.28	0.415	0.365
1996	0.323	0.28	0.398	0.351
1997	0.329	0.29	0.398	0.350
1998	0.337	0.30	0.403	0.354
1999	0.336	0.30	0.416	0.364
2000	0.354	0.32	0.438	0.385
2001	0.36	0.32	0.447	0.395
2002	0.365	0.32	0.450	n.a.
2003	0.368	0.33	0.479	n.a.
2004	0.37	0.33	0.473	n.a.
2005	0.38	0.34	0.485	n.a.
2006	0.37	0.34	0.487	n.a.
2007	0.37	0.34	0.484	n.a.

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2008	0.38	0.34	0.491	n.a.
2009	0.39	0.34	0.49	n.a.
2010	0.38	0.33	0.481	n.a.
2011	0.37	n.a	0.477	n.a.
2012	n.a	n.a	0.474	n.a.

Source: (Shi, 2012)

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