Since 1978 when China began to adopt market systems and particularly after 2001 when it joined the World Trade Organisation (WTO), the Chinese economy has grown rapidly on the back of a macroeconomic combination of investment and net exports. On the surface, this investment/net exports combination looks to have been successful. The country has developed to become the world’s manufacturing centre, using much of the world’s resources and investment monies to produce final goods that it supplies back to satisfy global demand for cheap manufactures.

Along the way, China has enjoyed the fastest sustained real GDP growth rate of any economy over the past 25 years, averaging 10.3 per cent (1980–1990) and 9.8 per cent (1990–2005). By 2006, China’s real GDP was over 12 times that of 1978 (its nominal GDP was 50 times greater), the country had become the world’s fourth largest economy and third largest trader, and it was driving much of the growth in world GDP: 15 per cent (2003), 25 per cent (2004), 40 per cent (2005), 33 per cent (2006) (World Bank 2007, US–China 2007). Inflation over the past decade has been low with periods of deflation that have helped keep up real growth. Unemployment has been consistently low, and China now enjoys the world’s largest current account surplus.

Table 1 shows the breakdown of China’s GDP by component. Note the rise in investment and net exports at the expense of household consumption. Investment in the form of government pump priming, government directed cheap bank loans to State Owned Enterprises (SOEs), and private foreign direct investment (FDI), has expanded to comprise over 40 per cent of GDP, accounting for 50 per cent of the country’s GDP growth between 2001–05. Net exports comprise almost 8 per cent of China’s GDP and account for 25 per cent of GDP growth (Lardy 2006). Household consumption, at 36 per cent, has dwindled in comparative importance. Chinese household consumption is now the lowest percentage of GDP of any major economy (for instance, in 2005, US 70 per cent, UK 60 per cent, India 61 per cent). Correspondingly, China’s household saving rate has steadily risen and now stands at 25 per cent of disposable income (Lardy 2006), high when compared with the slightly negative household saving rates of Australia and the US.

Table 2 records the movements in China’s major macroeconomic variables over the past decade and some predictions for the next two years.

STUDENT ACTIVITIES

1. Give explanations and examples of the following terms:
   - investment
   - net exports
   - household consumption

2. Using evidence from Table 1 and examples from the text, what have been the main factors driving China’s growth over the period shown?

**Table 1: China’s GDP breakdown**
Source China National Bureau of Statistics (as calculated by author)

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<thead>
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<tbody>
<tr>
<td><strong>Consumption</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Household consumption</td>
<td>48.8</td>
<td>51.1</td>
<td>46.4</td>
<td>38.0</td>
<td>36.4</td>
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<tr>
<td>Government</td>
<td>13.2</td>
<td>12.8</td>
<td>14.6</td>
<td>13.9</td>
<td>13.7</td>
</tr>
<tr>
<td><strong>Investment</strong> (gross capital formation)</td>
<td>38.2</td>
<td>37.0</td>
<td>36.5</td>
<td>42.6</td>
<td>40.7</td>
</tr>
<tr>
<td><strong>Net exports</strong></td>
<td>-0.2</td>
<td>-0.9</td>
<td>2.5</td>
<td>5.5</td>
<td>7.8</td>
</tr>
</tbody>
</table>
Despite the rapid growth and positive macroeconomic indicators, for the past three years China has been in the process of overhauling its economy. It has had to. While effective in the shorter-run, China’s investment/net exports growth path is proving unsustainable in the longer run. China’s often conflicting demand management policies have allowed economic growth that is too rapid, too unbalanced, too reliant on the inflow of external money (FDI and export revenues) and too wasteful of energy and resources. Accompanying investment/net exports growth are: a neglect of domestic consumption, falling capital productivity, limited employment prospects, a poisonous physical environment, rapid resource depletion, energy wastage, growing trade tensions, and increasing social inequality.

From 2005, the government has sought to redress these problems. Under the country’s eleventh five-year plan (2006-10) and ongoing policy pronouncements, the government is seeking to slow economic growth slightly while securing its balance and sustainability. It has introduced a package of economic policies that it hopes will shift the country’s growth pattern. These policies include:

**Monetary policy**
In the wake of the mid 1990s Asian currency crisis, the Chinese government eased monetary policy to encourage capital investment. It steadily reduced interest rates and expanded the money supply (PRC 2006) – see Table 3. The ensuing rapid capital investment, though, has led to over production and excess capacity (especially in the steel, autos, cement, and property industries), resulting in the build up of excess stocks, falling final prices, rising inefficiency in resource use, and falling growth rates in *multifactor productivity* (the effective combining of labour and capital) from 4 per cent (1978–1993) to 3 per cent (1994–2005) (Lardy 2006). It has also been heavily polluting and energy inefficient.

Over 2005–07, the government has actively used monetary policy to discourage inefficient investment (but not to discourage household consumption). It has steadily lifted interest rates (raising the cost of capital) and bank reserve requirements (tightening liquidity), the latter rising 10 times though 2007 alone. In December 2007, China’s monetary stance was officially changed from ‘prudent’ to ‘tight’ for the first time in 10 years (Chinese Government 2007). Interestingly, the money supply (defined as $M_2$ – cash plus deposits) continues to grow strongly each year.

**Fiscal policy**
China’s fiscal policy is now aimed at rebalancing the economy by shifting demand towards consumption and providing incentives for investment and production to move away from export-oriented manufacturing towards services that supply the domestic market (World Bank 2007). Budget deficits are being reigned in (Table 3) and tax reform is being used to fine tune China’s new economic structure with tax breaks to service-based, technology-oriented, green industry. Domestic household consumption is being encouraged through salary increases, extensions to national holidays and tax relief.

### Table 2: China’s major macroeconomic variables (1997–2008)

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<tr>
<td><strong>Real GDP growth (pa)</strong></td>
<td>9.3</td>
<td>7.8</td>
<td>7.6</td>
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<td>8.3</td>
<td>9.1</td>
<td>10.0</td>
<td>10.1</td>
<td>10.2</td>
<td>10.7</td>
<td>11.4</td>
<td>10.0</td>
<td>8.3</td>
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<tr>
<td><strong>Inflation (%) (CPI)</strong></td>
<td>2.8</td>
<td>-0.8</td>
<td>-1.4</td>
<td>0.4</td>
<td>-0.8</td>
<td>1.2</td>
<td>3.9</td>
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<td>1.5</td>
<td>4.6</td>
<td>3.0</td>
<td>3.5</td>
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<tr>
<td><strong>Urban unemployment (%)</strong></td>
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<td>3.1</td>
<td>3.1</td>
<td>3.1</td>
<td>3.6</td>
<td>4.3</td>
<td>4.2</td>
<td>4.3</td>
<td>4.3</td>
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<tr>
<td><strong>Balance of trade (US billion)</strong></td>
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<tr>
<td>Exports</td>
<td>182.8</td>
<td>183.7</td>
<td>194.9</td>
<td>249.2</td>
<td>266.1</td>
<td>325.6</td>
<td>438.2</td>
<td>593.3</td>
<td>762.0</td>
<td>969.1</td>
<td>1216.1</td>
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<td>Imports</td>
<td>142.4</td>
<td>140.2</td>
<td>165.7</td>
<td>225.1</td>
<td>243.6</td>
<td>295.2</td>
<td>412.8</td>
<td>564.2</td>
<td>660.1</td>
<td>791.6</td>
<td>953.9</td>
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<td>Net Exports</td>
<td>40.4</td>
<td>43.5</td>
<td>24.1</td>
<td>25.1</td>
<td>22.5</td>
<td>25.4</td>
<td>25.4</td>
<td>29.1</td>
<td>101.9</td>
<td>177.5</td>
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<td><strong>Disposable income (Yuan pc)</strong></td>
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<tr>
<td>Urban</td>
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<td>5425</td>
<td>5854</td>
<td>6280</td>
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<td>7702</td>
<td>8472</td>
<td>9421</td>
<td>10493</td>
<td>11759</td>
<td>–</td>
<td>–</td>
<td></td>
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<tr>
<td>Rural</td>
<td>2090</td>
<td>2162</td>
<td>2210</td>
<td>2253</td>
<td>2366</td>
<td>2475</td>
<td>2622</td>
<td>2936</td>
<td>3255</td>
<td>3587</td>
<td>–</td>
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<tr>
<td><strong>Yuan</strong></td>
<td>8.3</td>
<td>8.28</td>
<td>8.28</td>
<td>8.28</td>
<td>8.28</td>
<td>8.28</td>
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<td>8.07</td>
<td>7.70</td>
<td>7.36</td>
<td>7.23</td>
<td>6.97</td>
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</tbody>
</table>

Source China National Bureau of Statistics and US-China (with forecasts by The Economist)
Inflation
Until recently there has been very little inflationary pressure in China. The rapid rise in China’s CPI over 2007 (4.7 per cent), though at an eleven year high, is not yet a cause for concern. The rise is driven by food prices (food prices make up one-third of China’s CPI). The non-food component of the CPI is up only 1.4 per cent. Overall, for 2006, the GDP deflator was only 3.6 per cent (World Bank 2007). The government is hoping to contain the developing asset bubbles in property and stock markets through the rising interest rates.

Unemployment
China’s official unemployment rate figure is traditionally low. This may be because it records only registered urban unemployed and ignores rural unemployment and underemployment. The country’s rapid rise in GDP, though, has not lead to a boom in employment. Indeed, the employment growth rate has fallen with the rise in capital investment, declining from 2.5 per cent (1978–1993) to 1 per cent (1994–2004) (Lardy 2006). China’s elasticity of employment is only 0.13 (a rise of 0.13 per cent employment for every 1 per cent rise in GDP) (ILO 2007). China is experiencing jobless growth because the investment/net exports growth path does not generate jobs in sufficient numbers. Its capital intensive heavy industry tends to hire fewer workers than would either light industry or service industry, and export growth has led to labour switching rather than labour generating effects. The government hopes to boost employment growth through a new emphasis on household consumption and tax cuts for service industries and small business.

STUDENT ACTIVITIES
3. Why is China in the process of overhauling its economy? Explain how it is doing this.
4. Refer to Table 2.
   a. Outline the trend for each of the indicators over the period shown

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<tbody>
<tr>
<td>IR (%)</td>
<td>10</td>
<td>7</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>5.31</td>
<td>5.31</td>
<td>5.31</td>
<td>5.58</td>
<td>5.85</td>
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<td>Mₜ (% increase over the previous year)</td>
<td>19.6</td>
<td>14.8</td>
<td>14.7</td>
<td>12.3</td>
<td>17.6</td>
<td>16.8</td>
<td>19.6</td>
<td>14.7</td>
<td>17.6</td>
<td>16.9</td>
</tr>
<tr>
<td>Yuan (billion)</td>
<td>923</td>
<td>1080</td>
<td>1319</td>
<td>1589</td>
<td>1890</td>
<td>2205</td>
<td>2465</td>
<td>2849</td>
<td>3393</td>
<td>4062</td>
</tr>
<tr>
<td>% change on previous year</td>
<td>16.3</td>
<td>16.9</td>
<td>22.1</td>
<td>20.5</td>
<td>19.0</td>
<td>16.7</td>
<td>11.8</td>
<td>15.6</td>
<td>18.1</td>
<td>19.7</td>
</tr>
<tr>
<td>% GDP</td>
<td>11.7</td>
<td>12.8</td>
<td>14.7</td>
<td>16.0</td>
<td>17.2</td>
<td>18.3</td>
<td>18.2</td>
<td>17.8</td>
<td>18.5</td>
<td>19.4</td>
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<td>Yuan (billion)</td>
<td>865</td>
<td>988</td>
<td>1144</td>
<td>1340</td>
<td>1639</td>
<td>1890</td>
<td>2172</td>
<td>2640</td>
<td>3165</td>
<td>3958</td>
</tr>
<tr>
<td>% change on previous year</td>
<td>16.8</td>
<td>14.2</td>
<td>15.9</td>
<td>17.0</td>
<td>22.3</td>
<td>15.4</td>
<td>14.9</td>
<td>21.6</td>
<td>19.9</td>
<td>25.1</td>
</tr>
<tr>
<td>% GDP</td>
<td>11.0</td>
<td>11.7</td>
<td>12.8</td>
<td>13.5</td>
<td>14.9</td>
<td>15.7</td>
<td>16.0</td>
<td>16.5</td>
<td>17.3</td>
<td>18.9</td>
</tr>
<tr>
<td>Fiscal balance (as % of GDP)</td>
<td>-0.7</td>
<td>-1.1</td>
<td>-1.9</td>
<td>-2.5</td>
<td>-2.3</td>
<td>-2.6</td>
<td>-2.2</td>
<td>-1.3</td>
<td>-1.2</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

Balance of Payments
As China’s portion of global trade has grown sharply from less than 1 per cent (1979) to over 6 per cent (2005) (Lardy 2006), so too have tensions with its trading partners (notably the US and EU). The two main criticisms levelled at China relate to its undervalued currency and trade protectionism.

Undervalued Currency
China uses the Yuan as a policy weapon. Pegged to the US dollar in 1998 during the Asian currency crisis, the Yuan has been kept well undervalued over the past decade. This, coupled with massive FDI intake, has helped drive export growth. Revalued 2.1 per cent in July 2005, the Yuan is now set relative to China’s 20 main trading partners and is allowed to float within a 0.5 per cent band per day. Since its July 2005 unpeg from Yuan8.28 = US$1, the Yuan has risen 12.4 per cent and now stands at Yuan7.36 to US$1 (Table 2). ‘Floating’ the Yuan and allowing it to rise slowly forces China’s exporters to become more efficient and to add value. However is not a clean float. There is still massive intervention by China’s central bank to ensure that the Yuan is valued at the amount at which the government wants it valued. Interestingly, since mid 2005, the Yuan has fallen against the Euro by almost the same amount as it has risen against the US$ (US-China 2007), as China has begun to buy Euros.

Table 3: Demand management policies - interest rates, money supply (M2) and government budget deficit (1997–2007)
Despite US criticism of supposed Chinese protectionism, it should be understood that, since joining the WTO and complying with its protocols, the Chinese economy is now twice as open as the US economy and three times as open as the Japanese economy. Furthermore, while China runs trade surpluses with the developed countries, it runs trade deficits with many of its Asian neighbours (Dollar 2005).

In China, capital investment, resource misuse, energy wastage, and environmental degradation are all interwoven. Rampant capital investment has been encouraged though the subsidization of oil, gas, electricity, and water. China’s urban water, for example, is priced at US$0.15 per M³, compared to US$0.51 per M³ in the US and $US1.45 per M³ in Germany. Petrol is priced at one-quarter that of the US (Dollar 2005, Liu 2006). China’s energy elasticity of GDP growth (the number of units of energy required to produce an additional unit of output) has deteriorated from 0.6 (1980s–90s) to 1.2 (2000s) (Lardy 2006). Estimates suggest that China uses three times as much energy per unit of GDP as the United States and nine times as much as Japan (Liu 2006). It is estimated that the resultant pollution may cost the Chinese economy between 8 per cent–12 per cent of GDP annually, due to medical-care expenses and damage to crops and marine products (Liu 2006).

The government hopes to solve this integrated problem by limiting inefficient investment. Over the past two years, it has enacted strict guidelines for new capital investment projects, including minimum rates of return and standards of energy efficiency. Its immediate goals are to reduce energy consumption per unit of GDP by 20 per cent and water consumption per unit of industrial value added by 30 per cent within five years (Chinese Government 2007). Heavy polluters are being shut down. To secure supplies of clean, renewable energy, the government has begun to diversify China’s energy mix with the addition of wind, geothermal, nuclear - with an initial target of satisfying 15 per cent of energy needs by 2020. It is also lowering energy use by heavy industry through technology upgrades and has begun to adopt market pricing at least for oil and water. (Liu 2006).

China’s recent monetary and fiscal policy changes seek to rebalance economic growth and to make it sustainable by encouraging household consumption in place of excessive, inefficient capital investment. Policy changes also seek to improve energy efficiency, cut resource waste and improve environmental quality. If the new policies take hold, China should, over time, continue its march to become the world’s largest domestic economy and the world’s largest trader, all the while becoming cleaner, greener, more socially equal, and enjoying a much stronger currency. To what extent recent growth is a precursor remains to be seen as more change is on the horizon. Chinese firms have recently begun to outsource some of their production, especially in the highly competitive field of clothing and textiles. More significantly, however, buoyed by massive foreign exchange inflows and export receipts, Chinese firms and government have begun to buy into the rest of the world through stakes in strategic overseas companies and industries, especially those relating to resource mining, oil and investment banking. Indicators all, that China has entered the newest phase in its global economic ascendancy.

The gini co-efficient is used by economists to show what is happening to income equality over time.

a. Use your textbook to find a definition of the gini-co-efficient
b. Explain how it is calculated
c. Refer to the data about China below

Gini coefficient

<table>
<thead>
<tr>
<th>Year</th>
<th>Gini coefficient</th>
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<tbody>
<tr>
<td>1978</td>
<td>0.30</td>
</tr>
<tr>
<td>1988</td>
<td>0.38</td>
</tr>
<tr>
<td>2002</td>
<td>0.46</td>
</tr>
</tbody>
</table>

1. What has happened to income equality over the time shown?
2. Using information drawn from the article above, give possible reasons for the changes to the gini co-efficient and the implications that this may have for China.

References


‘Economics as the study of people, by people and for the people’
Economics is about people. It is about understanding how people’s decisions and actions result in particular patterns of production and consumption, wealth and poverty. The tools with which we develop that understanding were also developed by people – key thinkers who have made economics what it is today, for better or worse.

It is important to stress this human aspect of economics because it contrasts with some popular misconceptions. Many people think of the economy as an impersonal machine, impelled by forces beyond our control. They talk of ‘market forces’, forgetting that markets are made up of people buying and selling, albeit people with quite different market power.

Economics students also often get the impression that economic theories have an independent, even permanent, status. The theory of demand and supply, or of the circular flow of income, is just ‘there’ as an accepted part of economic knowledge. In fact, different economic theories have been developed over a long period of time, and many of them are quite incompatible with each other.

So a study of economics needs a focus on this human element. We need to see economics as the study of people, by people and for the people. Economic theory has a social purpose – to help us understand the economy so that we can improve how it works. We must aim to make the economy serve the needs of the broader society.

Those ambitions were clearly evident in the contributions of the most influential economic thinkers of the last three centuries, including Adam Smith, David Ricardo, Karl Marx, Alfred Marshall, Thorstein Veblen, John Maynard Keynes, John Kenneth Galbraith and Milton Friedman. Let’s look first at the last two, who both died in 2006: together, they illustrate the controversial nature of economics as a social science.

STUDENT ACTIVITIES
1. According to Stilwell, what is Economics about and what is its social purpose?
2. Internet Research Activity
   Working in small groups and selecting one or two terms each, it may be useful to gain some background understanding of terminology that you are about to cover. Use The Economist’s dictionary website on <www.economist.com/research/Economics> to find the meaning of the following terms:
   • classical economics,
   • neo-classical economics,
   • capitalist,
   • liberal or laissez-faire,
   • communism and feudalism,
   • Keynesianism
   Present your findings as a short report to be shared with others in the class.

Galbraith and Friedman – contrasting values in economics
Galbraith and Friedman held economic viewpoints that have been at loggerheads over the last half century. Galbraith represents the institutional tradition of economics, seeing the capitalist economy as inherently unstable and inequitable, needing to be controlled in the public interest by a social democratic government. Friedman saw too much government as the problem, and used neoclassical economic theory to support what came to be known as ‘neoliberal’ political prescriptions for more market-oriented economy.

Can we say one was right one was wrong? All economists have their own personal views, shaping their economic viewpoints. Is efficiency more or less important than fairness? Is faster economic growth a good thing if it causes environmental damage or a more uneven distribution of income? On such matters reasonable people may reasonably disagree.

Figure 1: Milton Friedman

Source: www.freetochoosemedia.org, Wikipedia

The disagreements also reflect different theories about how the economy works. Galbraith took the view that powerful institutions structure the economy to serve their own interests. Big corporations, operating on a global scale, can benefit from playing one country off against another to get low wage labour, cheap resources and low company tax rates. Business interests thereby often operate against the public interest. Friedman was more complacent about their possible abuse of economic power, arguing that competition between businesses would keep them under control. Consumers would have the ultimate power because they are ‘free to choose’ whose products to buy. So he favoured only minimal government ‘intervention’, arguing that regulations purporting to serve the public interest distort the ‘level playing field’ created by a market economy.
One could hardly imagine two more contrasting interpretations of how the modern capitalist economy works and whose interests it serves. The corresponding policy prescriptions stood in equally stark contrast. Galbraith advocated more extensive government policies to regulate businesses, create jobs, redistribute income and provide social services. Friedman advocated dismantling those policies in order to give freer reign to businesses to drive economic growth.

Whose advice did the politicians listen to? Galbraith had more traction during the quarter century after the second world war when governments were actively concerned with steering the economy, and developing the welfare state. Friedman’s economic prescriptions have been more influential subsequently. They were enthusiastically embraced by the fascist dictator, General Pinochet, in Chile and also, somewhat less brutally, implemented by President Ronald Reagan in the USA, Prime Minister Margaret Thatcher in the UK and John Howard in Australia. The general ideas and policies that Friedman promoted, setting aside some now discredited views on monetary policy, are now generally known as neoliberalism.

To understand neoliberalism, and alternatives to it, it is necessary to probe further back into the history of economic ideas.

**Adam Smith – economics as moral philosophy**

Adam Smith’s pioneering contribution to economic thought is the obvious place to start. Smith was Professor of Moral Philosophy at the University of Glasgow in Scotland in the late eighteenth century. He is generally known as the father of modern economics because he was the first to develop a comprehensive understanding of the market economy as capitalism was emerging from feudalism.

Smith observed that self-interest was a strong driver of productive economic activity.Buyers and sellers in the marketplace would make mutually advantageous exchanges. An increasingly complex division of labour in production processes would make more goods available too, as he demonstrated by an example of a factory producing more pins when its workers undertook specialised tasks.

Smith also saw significant dangers in the new market freedoms. He worried that the division of labour, while enhancing productivity, would render workers as ‘stupid and ignorant as it was possible for a human creature to become’. He thought that businesspeople could not be trusted because of their tendency to collude and raise prices. And he recognised that government would need to play a significant role in defending citizens against social injustices of various kinds, notwithstanding his general support for the market economy.

**David Ricardo – economic progress but for whom?**

Ricardo built on Smith’s economic analysis, studying capitalism in the nineteenth century as the industrial revolution was transforming the primarily agrarian society of Britain and other European nations. He believed that the growth of international trade would be crucial to the success of the new economy, providing demand for the growing volume of goods and services being produced.

Trade, he argued, should proceed on the logic of comparative advantage, with each nation specialising in producing goods for which they were relatively best suited, and then exchanging the goods for mutual advantage. Restrictions on trade should be removed. Such restrictions, Ricardo argued, tended to benefit landowners at the expense of the rest of society.

Ricardo thought that landowners would get a growing share of the incomes generated by economic growth. The living standards of the bulk of the population would be kept down by the effects of population growth, according to the Reverend Thomas Malthus, another classical political economist. But Ricardo thought that the process of capital accumulation would also be constrained by landowners capturing a growing share of the economic surplus for themselves. The prospect was for a ‘stationary state’ in which the economy would tend to stagnate.

**Karl Marx – the critique of capitalism**

Marx thought the prospects for capitalism were yet more dire. He acknowledged that it was a progressive economic system, relative to the previous systems of slavery and feudalism. It would unleash tremendous productive potential, using new technologies to serve the ambitions of profit-seeking capitalists. But the class conflict between the capitalist class and the working class would prevent it being an affluent society for all.

Workers’ wages would be kept down, not by the pressures of population growth that Malthus emphasised, but by the reserve army of labour that resulted from unemployment. The capital accumulation process would generate its own contradictions, as the increased capital-intensity of production caused the rate of profit to fall.

Marx drew on the labour theory of value developed by Smith and Ricardo and gave it a radical twist to reveal how profit resulted from the exploitation of labour. His prediction of the collapse of capitalism has not yet come to pass in western societies, but his analysis of the conflicts embedded in the system has enduring value. The conflicts over the Howard Government’s WorkChoices legislation and how it changed Australian industrial relations are a case in point.

**Alfred Marshall – studying markets in equilibrium**

Marshall interpreted the capitalist market economy in a more favourable light. His neoclassical theory became the new orthodoxy at the end of the nineteenth century. On Marshall’s reasoning, the forces of demand and supply would produce equilibrium in each and every market where they were allowed to freely operate. This neoclassical theory continues to provide the foundation for most orthodox economic thinking today, as studied in HSC Economics for example.

Marshall’s textbook set out the basic theory of supply, demand and equilibrium, with a theory of market prices that put emphasis on consumers’ demand as well as firms’ production costs. This neoclassical theory set aside the big concerns about class conflict, the distribution of wealth and the evolution of capitalist society.

Marshall’s theorising separated economics from the study of society and politics. It emphasised competitive markets at a time when the real world was taking a different
direction – with the growth of big business, trade unions and an extensive role for government in managing the empires that the major capitalist nations had then acquired.

**Thorstein Veblen – emphasising economic and social institutions**

Veblen, an American political economist of Norwegian descent, thought it would be more useful to study the changing conditions in the real world rather than focus on abstract neoclassical economic models. He put particular stress on the changing patterns of consumer spending. He noticed how ‘social emulation’ had become important in shaping ‘conspicuous consumption’. He laid the foundations for the analysis of consumerism, which is so clearly a feature of modern society.

Veblen also revealed a fundamental tension arising from business control over the production of goods and services, sometimes blocking the progressive potential of technological change. Financial interests caused technological change to be suppressed where it threatened the power structures of monopolistic business.

**Figure 2: John Maynard Keynes**


**John Maynard Keynes – patching up a faulty system**

Keynes is widely regarded as the greatest economist of the last century. He taught at Cambridge University in the UK between the two great world wars. He was a brilliant intellect, unwilling to accept the prevailing economic orthodoxies because they were incapable of solving the economic problems of the real world.

The inter-war years featured recurrent unemployment, particularly during of the Great Depression. The neoclassical economic orthodoxy interpreted the unemployment as due to wages. However, as Keynes observed, wage-cutting made the unemployment worse because it caused the total spending on goods and services to fall.

Keynes showed that the main source of the unemployment problem was the deficiency of aggregate demand. He also proposed a practical solution - government expenditure that would have the effect of boosting incomes, demand and employment. The vicious cycle of depression could thereby be converted into a virtuous cycle of expansion.

Monetary policy could supplement discretionary fiscal policy, along with other policy instruments that would produce full employment.

Keynes died sixty years ago, and his macroeconomic analysis and policy prescriptions have been variously in and out of favour since then. Galbraith supported them; but Friedman opposed the use of Keynesian policies, effectively returning orthodox economic reasoning to its pre-Keynesian state.

**Student Activities**

3. Briefly outline Galbraith’s and Friedman’s views about the role governments and consumers should play in modern economies. Why were their approaches so different?

4. Why was Adam Smith seen as the ‘father of modern economics’? Outline the problems he foresaw for workers, business people and governments?

5. David Ricardo was a great believer in the advantages associated with free trade. What were these believed to be?

6. Why did Marx believe that capitalism would ultimately result in its own self-destruction?

7. Keynes believed that the main method for avoiding unemployment and downturns in the economy was through management of aggregate demand. Based on your reading of this article, how did he say this could be achieved?

**Conclusion**

So what makes a key economic thinker? The capacity to address the big issues of the era is crucial, as is the recognition that economic arrangements must serve broader social goals. Values such as fairness, freedom and sustainability are crucial in the formulation of economic policies to serve social progress. All the key thinkers in economics have been concerned with these big issues of political economy.

The biggest challenges today concern how the economy relates to the environment and the society. Our current economic arrangements are not ecologically sustainable, and recurrently violate community concerns about social justice. We can learn much from previous key economic thinkers about how to tackle these issues, but we also need further innovation in political economic analysis. Will the next key thinker please step forward?

**Extension Activity**

Class Debate – form groups to present arguments for and against the following topic: ‘Modern economies should be guided by the market and have minimal government regulation of business’.

**Suggested Further Reading:**


WHY INDIA WILL ROCK OUR WORLD

On the surface Australia now appears hooked on swamping rocks for Chinese boxes. True, but fairly glib and deceptive all the same. The content of these boxes is normally not Chinese at all and many of our rocks (particularly coal) go elsewhere in Asia.

What is different this decade is a revamp of Asian production, with bits and pieces made everywhere being finished off in the Middle Kingdom. China is still largely an assembler, not a manufacturer. Those who do these sums reckon only about 25 cents in every dollar in the boxes is in fact Chinese. The majority comes from elsewhere, especially Japan, Taiwan and Korea.

A China-based banker tells of his colleagues stripping apart a Chinese-made iPhone to find not a single mainland part. Unlike the original lowly paid Chinese assembler, the highly paid bankers could not put it back together. More generally, Japanese, Korean and Taiwanese exports to the US have been broadly flat this decade, many of their goods taking a Chinese detour. Feral US politicians now vent their anger on the Chinese, much to the relief of diplomats from Tokyo, Seoul and Taipei.

What caused this change to a pan-Asian production process was a foreign investment-friendly Chinese Government armed with a seemingly endless supply of young peasants stuck on the farm with no prospects of doing anything productive. The switching of unproductive farm labour into factories has been behind most growth take-offs since the British industrial revolution.

So, Chinese teenagers and twentysomethings poured into dorms, factories and building sites on the coastal strip to be employed mainly by foreigners. In the process, for example, the Korean textile industry, which used to supply David Jones’s house-brand shirts a decade ago, was destroyed, just as it had earlier gazumped the Japanese. At the start of this decade nearly 15 per cent of Korea’s exports were textiles, bags, toys and other entry-level, low-value industrial goods. Now the slice is under 5 per cent. Why do you think Korean policymakers are so keen on high-speed broadband?

Nothing lasts forever. The seemingly endless Chinese reserve army of rural underemployed is dwindling, partly because of previous success, partly because the one-child policy is beginning to bite, and partly because policymakers realised their grip on power would be tenuous if the rural hordes turned green with envy over better incomes on the coast.

That doesn’t mean the end of the Chinese boom (and its Australian consequences), as the politburo strives to spread prosperity westwards. Urbanisation continues apace, but increasingly to inland cities few in Australia had heard of a decade ago, though a city 1000 kilometres from the sea is not the ideal place from which to import Asian components and re-export to the US or Europe, even if it is on the Yangtze.

China is going upmarket to justify higher wages, its strategy being to convert its 25 per cent share of the export box into 30 then 40 per cent. It is becoming a value-added manufacturer, not just an assembler. There will be cheap Chinese cars on our streets before long. Meanwhile, global manufacturers are looking around for new sources of cheap assembly workers. Vietnam has been a favourite, and Indonesia could fit the bill if it ever got its act together.

Enter an India that discovered early last decade its inability to afford ‘Hindu-style’ non-materialism. Now its economy is growing about 9 per cent a year. And it isn’t simply a place from whence pesky phone calls emanate or to where back-office jobs disappear. Manufacturing has been growing even more rapidly than services, and for now there is still a vast supply of labour.

But India has been too much trouble, in the form of lousy infrastructure, red tape, endless court cases and labour rigidities. Not for much longer. Highways covering 5846 kilometres and connecting the Golden Quadrilateral of Delhi, Mumbai, Chennai and Kolkata are almost complete, and the Government is seeking to nearly double economic infrastructure investment over the next five years to 9 per cent of national income.

Chief executives of the globe’s 1000 biggest firms nominate India second only to China as the best place for foreign investment (Australia is eighth). The chart of dollar inflows snakes upwards, eerily like China’s in the first 15 years after that country opened its doors in 1978.

Extract from ‘Why India will rock our world’ by Barry Hughes, The Sydney Morning Herald, p.9, Wednesday 2 January 2008.

STUDENT ACTIVITIES

1. Explain why China has been successful as an assembler of manufactured goods.
2. Compare the key elements of China’s growth phase to that of Korea and Japan.
3. How could China maintain its economic growth rate when its supply of cheap labour falls?
4. Assess the likely future for economic growth in Vietnam, Indonesia and India.
5. How are the emerging manufacturing trends in Asia likely to affect the Australian economy?