

Trade and Trouble

What China Can Learn from the 1640 Economic Bust

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In 1514, the Portuguese navigator Jorge Álvares was the first European to reach China by sea. Just over 40 years later, the Portuguese leased Macau from China for an annual rent of about 600 ounces of silver. And then, 14 years after that, the Spanish colonized Manila as the hub of their transpacific trade. By 1600, trade in Chinese goods was in full swing. China became an export powerhouse, and not for the last time.

The problem for Europeans was that Chinese traders didn't need anything from Europe. Trade with China was strictly cash-and-carry—and cash meant silver. In the century or so between the first European sea contacts with China and the year 1640, European ships carried something like 100,000 tons of silver to China from mines in central Europe, Japan, and the Americas.

The massive influx of precious metal helped transform the Chinese economy from a nonmonetary economy based on feudal obligations and barter trade into a monetized economy based on market exchange. China had experimented with paper money early on, but even the government did not accept that paper as payment for its own taxes. And so the monetization of China's large economy required boatloads of foreign money—just what Europe sent.

Between 1568 and 1644, the price of silver in China (relative to gold) eased by 50 percent. By 1580, there was enough silver in the economy for the Ming dynasty to convert a variety of feudal labor and crop levies into modern taxes payable in coin. Wages and prices rose and rose as silver money became more plentiful.

Soon, China was the manufacturing workshop of the world, at least so far as the sailing technology of the time made that possible. The country's two major centers of export-oriented production were the Pearl River Delta (modern Guangzhou, Hong Kong, and Macau) and the Yangtze River Delta (modern Shanghai, Hangzhou, and Suzhou). Chinatowns sprang up throughout the Spanish New World, with Spanish colonial authorities warning that Chinese imports were undercutting home industries.

Around 1640, though, the party ended; trade crashed and poor harvests brought famine to northern China. The price of silk declined by 50 percent as producers scrambled to find buyers for their output. Meanwhile, the price of food shot up, so the deflation of the factory sector was accompanied by a rising cost of living for ordinary people. Soon, rebellions broke out, Manchu invaders took Beijing, and the Ming dynasty fell. It was replaced by the Qing dynasty, which would rule China until the early twentieth century.

Of course, trade in Chinese goods didn't come to an end in 1640. What came to an end that year was superprofitable arbitrage resulting from the collision of two different economic systems. Before 1640, Europe's glut of cheap New World silver intersected with China's seemingly insatiable appetite for silver money to drive massive wealth creation on both sides. Trade with China wasn't just profitable; it was sensational. But after 1640, the global value of silver equalized and China became

just another port of call in the international trading system. Silver still flowed into China, but so did ginseng, furs, and opium. Tea, silk, and porcelain continued to flow out.

THE SECOND BOOM

Just as in the 1600s, the basic underlying logic of China's economic boom after 1980 was the import of money in exchange for the export of goods. China's first integration with the West in the late 1500s and early 1600s looked an awful lot like China's second integration with the West between 1980 and 2010. Both resulted in massive opportunities for arbitrage from the connecting of two previously isolated economies. Both resulted in massive profits for Western traders and Chinese merchants. And both petered out once the Chinese economy was fully inflated by Western money.

In the 1970s, China was an isolated country with an economy based mainly on communal obligations and barter trade. Most people received most everything they needed from their work units. Rural people lived off the land, remitting a portion of their produce to the government. Urban people lived in factory housing, ate in factory cafeterias, and worked in factory uniforms.

Money was a scarce commodity in Communist China, and Western hard currency was rarer still. After 1980, China imported massive quantities of hard currency in the form of foreign direct investment and central bank accumulation of U.S. dollars. It exported consumer goods in exchange.

Just as in the 1600s, the basic underlying logic of China's economic boom after 1980 was the import of money in exchange for the export of goods. This influx of money supported the full remonetization of the Chinese economy. Goods and services that the state or the work unit had previously provided now had to be bought in the marketplace.

China's GDP per capita grew by a factor of 13 between 1980 and 2010. If this sounds too good to be true, that's because it is too good to be true. China's economy did experience enormous growth after 1980, but no economy really grows by a factor of 13 in just 30 years. China's recorded growth is partly due to true economic progress and partly due to the monetization of previously nonmonetary relationships.

Today, both sources of recorded GDP growth are disappearing. Before 2007, China's foreign currency reserves were large in absolute terms but more or less in line with those of many other developing countries. When the global financial crisis struck, China's reserves ballooned. They have remained high ever since.

This suggests that China's once insatiable demand for hard currency has finally run its course. Investment flows tell the same story: China is now a net exporter of foreign direct investment. After three decades of massive monetary inflows, the Chinese economy is fully inflated and fully monetized. It's 1640 all over again.

Now that the easy money is gone, China will have to chase the hard money to finance its future growth. So far, China's leaders have shown little appetite for the kinds of public-spirited sacrifices that have made the United States what it is today. True growth in China's underlying economic output is slowing thanks to a falling working-age population, a degraded environment, and inadequate political institutions. China is converging with Brazil, Russia, and Turkey, not with the United States, Europe, and Japan. China's monetary saturation only reinforces this trend. As China's economy becomes more and more open, money is flowing out, not in.

The years after 1640 were ones of great turmoil in China, culminating in famine, revolution, and invasion. Today's Chinese state is much more robust than the Ming dynasty was. There will be no

famine, revolution is unlikely, and no one is in a position to invade China. But the money-fueled profits party is over. From now on, it will be "business as usual" in China.

China's new challenge is to develop the social and political institutions that will allow it to continue improving the lives of its people. There is no magic formula. A good start would be to implement a more effective national income tax to replace China's hodgepodge of unreliable revenue sources. Continued growth requires continued investment in human and physical infrastructure, and that requires taxes.

Now that the easy money is gone, China will have to chase the hard money to finance its future growth. So far, China's leaders have shown little appetite for the kinds of public-spirited sacrifices that have made the United States what it is today. As countries such as Brazil, Russia, and Turkey illustrate, it is possible for leaders to live quite well in stagnant economies. More than a billion people have to hope that China's leaders will rise to the challenge.