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Comment Michael Dooley

This chapter provides a careful evaluation of the contribution of export growth to growth in manufacturing employment in China in recent years. Feenstra and Hong are generous in citing my work with Folkerts-Landau and Garber as providing an incentive to evaluate the role of export industries in absorbing some 250 million underemployed workers over the next decade or so. They find that our back-of-the-envelope calculation that exports have generated one-third of the growth in employment is roughly consistent with their estimates generated from input-output data adjusted for productivity

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growth. These adjustments reflect the fact that in traded goods industries, output has grown much faster than labor inputs.

Their interpretation of this evidence, however, is quite different from ours. They observe that shifting toward domestic demand might stimulate more employment for a given growth rate. We have argued that an effective development strategy provides workers capital and technology that generates an improvement in labor productivity. It follows that relatively slow growth in employment is a necessary condition for a successful development strategy.

Productivity growth could, in principle, come from growth in traded (including agriculture) or nontraded goods output. Moreover, this growth in output could be supported by domestic or foreign demand. In any case, employment must grow more slowly than output for real wages to rise. If productivity did not increase, there would be little point in switching labor from one sector to another.

Feenstra and Hong provide important evidence that domestic demand for traded goods has actually declined in China in recent years and suggest that policies that encourage the domestic demand would be just as effective as export demand in supporting traded-goods industrialization and growth. True, but if the mechanism for accomplishing this is real appreciation of the exchange rate China would lose the incentive for foreign firms to risk their capital in China and the associated transfers of technology.

We do not offer, nor have we found, a theoretical reason for favoring one development strategy over another. For example, the strategy of import substitution industrialization popular in Latin America until recently might have succeeded. The idea here was to switch domestic demand from imports to domestic manufactured goods. It was assumed that productivity growth in the industrial sector would generate economic growth and rising real wages. But the clear evidence is that it did not.

There is the possibility, of course, that this need not have been a problem for the international system at all. If there is unemployed labor and inefficient capital formation in emerging markets, why not reform their domestic institutions and rely on domestic markets to create employment and economic growth? A recurrent criticism of our approach is that we focus on growth in export industries and participation in international financial markets and neglect the contribution of development of domestic goods and financial markets. Clearly, domestic demand that supports the expansion of high-productivity jobs and capital accumulation is as good as international demand.

We do not know why inward looking development polices such as the import substitute industrialization popular in Latin America have been such dismal failures or why it has proven so difficult to reform domestic financial markets. We only point out that if we were responsible for the development strategy of a poor country, we would not find many historical examples of successful inward looking strategies. The only thing we are sure of is that we reject categorically assertions that "economic theory" tells us much about what will and will not be a successful development strategy.

It would be wonderful to reform the domestic financial systems in emerging markets because this would liberate domestic savings for efficient capital formation. But we observe that it is more effective to bypass the domestic financial system by allowing capital flight from the country to return in the form of direct or equity investment. This replaces the distorted domestic allocation incentives. It also threatens the rents captured by domestic financial institutions as their business is lost to international markets. The domestic reaction, of course, is to tighten controls on capital flows. But at some point the threat of replacement will generate reform.

From a macroeconomic perspective, China's large savings have been more than sufficient to finance its own development. However, its poor domestic financial system, its need for foreign technology and management skills, and its need to pry open foreign markets were insurmountable barriers to a purely domestic approach based on domestic demand. The solution to the problem came about perhaps by chance—implement the macroeconomic policies outlined in the preceding, let foreign financial markets partially intermediate Chinese savings, let foreign capital profit from the strategy, and thereby split the interests of foreign labor and capital to keep open the export markets.