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China's Recovery and Global Growth

by Martin Feldstein

CAMBRIDGE – China is likely to be the first of the major economies to recover from the current global downturn. Its pace of expansion may not reach the double-digit rates of recent years, but China in 2010 will probably grow more rapidly than any country in Europe or in the western hemisphere.

But, even as China recovers from its current slowdown, it is not likely to provide a similar boost to all of its trading partners. That lack of spillover will reflect the recovery's focus on expansion of domestic demand.

There is no doubt that China currently is suffering from the global collapse in demand for a wide range of manufactured products. The sharp drop in retail sales in the United States and Europe means fewer orders for the goods produced in Chinese factories.

And, while the Chinese yuan has remained more or less unchanged relative to the US dollar in the past year, the dollar's sharp appreciation relative to the euro and other currencies caused the overall trade-weighted value of the yuan to rise. This further depressed Chinese exports.

The resulting layoffs of Chinese factory workers has caused second-round declines in local demand for Chinese goods and services, as Chinese households cut back on their spending. Small firms that exported 100% of their production have been forced to close. Millions of low-skilled workers who left farms in China's interior to work in coastal manufacturing centers are now being forced to return to their villages. The families benefiting from their remittances will now be forced to cut their consumption as well.

The Chinese authorities are determined to reverse the resulting decline in growth in order to reemploy those who have lost their jobs and to create employment for the millions of young people who join the labor force each year. Failure to do so would not only create hardship for the millions of unemployed, but would also threaten political stability, which depends on the expectation of continuing economic prosperity.

The government's initial policies aimed at raising aggregate demand focused on major infrastructure spending, including roads and mass transit. But the more significant strategy is to alter government policies in ways that will lead to higher spending by Chinese consumers, and that raise the level of those government outlays, like health care, which directly benefit Chinese households.

Spending by China's consumers has lagged behind the Chinese economy's overall rate of growth for many years. This reflects the declining share of wages in total GDP and the rising share of savings relative to household incomes. To raise consumer spending, the Chinese government must reverse both of these trends.

Although private enterprises are the fastest growing part of the Chinese economy, enterprises that are partially or fully owned by the state continue to be major employers. The government can directly affect wage levels in these firms, thereby altering the general wage level in the economy.

The high saving rate of Chinese households reflects both the normal high rate of saving among younger generations and the fact that older generations had very little income – and therefore did very little saving – when they were young. The aggregate saving rate of the household sector reflects the difference between the saving of the savers and the dissaving of the dissavers. Since the saving of younger savers is now high and the dissaving of the older dissavers is low, the net saving rate is high.

Young people have many reasons to save. The public pension system is unreliable, there is little health insurance available to pay for the high cost of Western-style care, parents must pay tuition for their children's schooling, there is little credit available for purchases of consumer durable, and buying an apartment requires a large down-payment.

I believe that the government will act on all of these reasons for high saving, making credit more widely available, introducing a health insurance system, and relaxing some of the down-payment requirements.

Premier Wen Jiabao made clear in his recent remarks to the People's Congress that he will do what it takes to stimulate demand in order to ensure strong growth in China. I have little doubt about his willingness and ability to do so.

Martin Feldstein, a professor of economics at Harvard, was formerly Chairman of President Ronald Reagan's Council of Economic Advisors and President of the National Bureau for Economic Research.