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China's Five-Year Plan and Global Interest Rates
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CAMBRIDGE – China's new five-year plan will have important implications for the global economy. Its key feature is to shift official policy from maximizing GDP growth toward raising consumption and average workers' standard of living. Although this change is driven by Chinese domestic considerations, it could have a significant impact on global capital flows and interest rates.

China's high rate of GDP growth over the past decade has, of course, raised the real incomes of hundreds of millions of Chinese, particularly those living in or near urban areas. And the funds that urban workers send to relatives who remain in the agricultural sector have helped to raise their standard of living as well.

But real wages and consumption have grown more slowly than China's total GDP. Much of the income from GDP growth went to large state-owned enterprises, which strengthened their monopoly power. And a substantial share of China's output goes abroad, with exports exceeding imports by enough to create a current-account surplus of more than $350 billion over the past year.

China now plans to raise the relative growth rate of real wages and to encourage increased consumer spending. There will also be more emphasis on expanding service industries and less on manufacturing. State-owned enterprises will be forced to distribute more of their profits. The rising value of the renminbi will induce Chinese manufacturers to shift their emphasis from export markets to production for markets at home. And the government will spend more on low-income housing and to expand health-care services.

All of this will mean a reduction in national saving and an increase in spending by households and the Chinese government. China now has the world's highest saving rate, probably close to 50% of its GDP, which is important both at home and globally, because it drives the country's current-account surplus.

A country that saves more than it invests in equipment and structures (as China does) has the extra output to send abroad as a current-account surplus, while a country that invests more than it saves (as the United States does) must fill the gap by importing more from the rest of the world than it exports. And a country with a current-account surplus has the funds to lend and invest in the rest of the world, while a country with a current-account deficit must finance its external gap by borrowing from the rest of the world. More precisely, a country's current-account balance is exactly equal to the difference between its national saving and its investment.

The future reduction in China's saving will therefore mean a reduction in China's current-account surplus – and thus in its ability to lend to the US and other countries. If the new emphasis on increased consumption shrank China's saving rate by 5% of its GDP, it would still have the world's highest saving rate. But a five-percentage-point fall would completely eliminate China's current-account surplus. That may not happen, but it certainly could happen by the end of the five-year plan.

If it does, the impact on the global capital market would be enormous. With no current-account surplus, China would no longer be a net purchaser of US government bonds and other foreign securities. Moreover, if the Chinese government and Chinese firms want to continue investing in overseas oil

resources and in foreign businesses, China will have to sell dollar bonds or other sovereign debt from its portfolio. The net result would be higher interest rates on US and other bonds around the world.

Whether interest rates do rise will also depend on how US saving and investment evolves over the same period. America's household saving rate has risen since 2007 by about 3% of GDP. Corporate saving is also up. But the surge in the government deficit has absorbed all of that extra saving and more.

Indeed, the only reason that America's current-account deficit was lower in 2010 than in previous years is that investment in housing and other construction declined sharply. If Americans' demand for housing picks up and businesses want to increase their investment, a clash between China's lower saving rate and a continued high fiscal deficit in the US could drive up global interest rates significantly.

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