

Is China Really Immune to the Crisis?

by *Kenneth Rogoff*

CAMBRIDGE – Addressing the annual World Economic Forum in Davos, Switzerland, Chinese Premier Wen Jiabao explained his government’s plans to counter the global economic meltdown with public spending and loans. He all but guaranteed that China’s annual growth would remain above 8% in 2009. Wen’s words were like warm milk to the recession-numbed audience of global political and business leaders.

But does the Chinese government really have the tools needed to keep its economy so resilient? Perhaps, but it is far from obvious.

America’s deepening recession is slamming China’s export sector, just as it has everywhere else in Asia. The immediate problem is a credit crunch not so much in China as in the United States and Europe, where many small and medium-size importers cannot get the trade credits they need to buy inventory from abroad.

As a result, some once-booming Chinese coastal areas now look like ghost towns, as tens of thousands of laid-off workers have packed their bags and returned to the countryside. Similarly, in Beijing’s Korean section, perhaps half of the 200,000-300,000 inhabitants – mainly workers (and their families) who are paid by Korean companies that produce goods in China for export – reportedly have gone home.

With roughly \$2 trillion in foreign-exchange reserves, the Chinese do have deep pockets to fund massive increases in government spending, and to help backstop bank loans. Many leading Chinese researchers are convinced that the government will do whatever it takes to keep growth above 8%. But there is a catch. Even if successful in the short run, the huge shift toward government spending will almost certainly lead to significantly slower growth rates a few years down the road.

Simply put, it is far from clear that marginal infrastructure projects are worth building, given that China is already investing more than 45% of its income, much of it in infrastructure. True, some of China’s fiscal stimulus effectively consists of loans to the private sector via the highly controlled banking sector. But is there any reason to believe that new loans will go to worthy projects rather than to politically connected borrowers?

In fact, China’s success so far has come from maintaining a balance between government and private sector expansion. Sharply raising the government’s already outsized profile in the economy will upset this delicate balance leading to slower growth in the future.

It would be preferable for China to find a way to substitute Chinese for US private consumption demand, but the system seems unable to move quickly in this direction. If government investment has to be the main vehicle, then it would be far better to build desperately needed schools and hospitals than “bridges to nowhere,” as Japan famously did when it went down a similar path in the 1990’s. Unfortunately, China’s local officials need to excel in the country’s “growth tournament” to get promoted. Schools and hospitals simply do not generate the kind of fast tax revenue and GDP growth needed to outperform political rivals.

Even prior to the onset of the global recession, there were strong reasons to doubt the sustainability of China’s growth paradigm. The environmental degradation is obvious even to casual observers. And economists have started to calculate that if China were to continue its prodigious growth rate, it would soon occupy far too large a share of the global economy to maintain its recent export trajectory. So a shift to greater domestic consumption was inevitable anyway. The global recession has simply brought that problem

forward a few years.

Interestingly, the US faces a number of similar challenges. For years, the US achieved fast growth by deferring attention to a variety of issues, ranging from the environment to infrastructure to health care. Even absent the financial crisis, addressing the shortcomings in these areas would likely have slowed down US growth.

This is not to say that the US and China are the same. One of the great challenges ahead is to find a way to bring these two countries' savings into line, given the vast trade imbalances that many believe planted the seeds of financial crisis.

I was reminded of the challenge recently when a Chinese researcher explained that men in China today feel compelled to save in order to find a bride. The same week, a former student of mine who lost his lucrative financial-sector job explained that he had no savings because it was so expensive to date in New York! These social differences have little to do with the yuan-dollar exchange rate, although that matters, too.

One way or the other, the financial crisis is likely to slow medium-term Chinese growth significantly. But will its leaders succeed in stabilizing the situation in the near term? I hope so, but I would be more convinced by a plan tilted more toward domestic private consumption, health, and education than to one based on the same growth strategy of the past 30 years.

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