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China's Growth Slowdown and Its Implications

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China's three and a half decades of near double-digit growth have transformed the nation from a predominantly rural and poor society into one of the world's three largest trading nations, possessing a first-world transportation system and a population that is increasingly "middle class" and urban. This rapid growth has led to the accumulation of more than $3.5 trillion in foreign exchange, much of it invested in U.S. Treasury securities and rapidly rising military expenditures. Today, however, that growth is slowing down, and there are good reasons to believe that it will slow further, with significant implications for the United States and the world.

THE CAUSES OF CHINA'S SLOWING GROWTH

The first thing to note is that China's decades of 9.5% annual growth constituted catch-up growth, sustained somewhat longer and at a higher level than the growth spurts of the four Asian tigers but basically similar in nature. Countries that have fallen far behind the most advanced economies can progress very rapidly if they get their policies right, have certain fundamentals in place, and maintain a stable environment for investment. That kind of growth, however, inevitably comes to an end, often dropping to 4%–5% or lower when incomes reach $10,000–$16,000 per capita in purchasing power parity (PPP) terms—largely because such countries must begin to rely on their own R&D and not simply follow the path forged by others. China's per-capita GDP in 2012 in PPP terms was between $9,000 and over $12,000, depending on which estimates one uses.

In China's case, there are a number of additional reasons this slowdown is occurring now:

Declining labor migration. The labor surplus in China's rural areas is beginning to come to an end, with most rural residents between the ages of 18 and 40 already working in the cities. Thus, the future productivity jump from moving rural labor into urban jobs will be limited to the children not yet old enough to move out of agriculture.

Cooling exports. China's growth was fueled by a long-running export boom, with exports during 2000–2008 growing at over 20% per year. After the 2008 global recession, the growth rate of exports slowed to 9.2% through 2012, and even this rate will be difficult to sustain. It will be a major challenge for China to maintain, let alone raise, its already high share of 9% of total world exports.

Overheated investment. China has an investment rate as a share of GDP of nearly 50%, which is an extraordinary figure. Investment rates near this level have been productive largely because China needed to meet a three-decade gap in both housing and transport investment. That gap has now been filled, and future investment will produce lower returns. The commercial real estate boom has also become a bubble in much of the country outside of Beijing and Shanghai. For example, in 2011–12 alone, China completed 3.8 billion square meters of housing space, enough to house well over 100 million people very comfortably. That rate is not sustainable.

Weak consumption. The solution to the problem of excessive investment is mainly to raise household consumption from its extraordinarily low level by international standards. Official household consumption figures are widely believed to be understated, but plausible revisions upward in the data would not change the nature of this challenge. There are various ways of helping increase household consumption, but most, such as measures to reduce savings by improving and expanding the welfare system, will take considerable time. The one sure solution would be for wages to grow faster than GDP.

That is occurring, but even if the trend continues, the problem will take a decade or more to correct itself.

POLICY IMPLICATIONS

For China, the major uncertainty in the short run is how much stimulus the government will pursue to maintain or manage the growth rate. In the past, the leadership has viewed large-scale stimulus efforts to sustain high rates of GDP growth as the key to political stability. There are still major infrastructure projects, such as completion of the high-speed rail system and moving water from the Yangtze to the north, but so far the new leadership has not been willing to pursue an all-out stimulus.

It should be emphasized that the slowdown is not yet building to a crisis that is likely to stop growth altogether. Major financial problems remain from the way the previous stimulus investment policies were financed by relying heavily on local governments with limited revenue bases. However, there are no real political constraints on the Chinese government in refinancing these local governments. Senior officials can and no doubt will use methods that basically involve printing money, much like they did when they refinanced the banking system.

What are the implications of this slowdown for the United States and U.S. policy? For the most part, China's economic slowdown will be driven by domestic conditions in China and the policy choices of its government, but there are some areas where U.S. policy can make a difference.

- China will continue to possess and likely increase its huge foreign-exchange holdings in U.S. Treasuries or other dollar assets, largely because there are few viable alternatives, and the renminbi will not soon compete with the dollar as the world's reserve currency.
- Foreign investors are likely to continue their extensive involvement in China. Footloose exporters of labor-intensive products are departing as Chinese wages grow in comparison with cheaper alternatives in places like Southeast Asia. But the size of the Chinese market, while facing declining growth in percentage terms, will continue to experience large increases in dollar terms because growth is now from a much higher base.
- China's military budget growth, which constitutes a rising share of GDP, might also slow, but the government will likely continue to forge ahead to build a military that can compete with anyone.
- The slowing of export growth, together with the fact that China will increasingly depend on its own R&D, should encourage China to be included in and meet the standards of the Trans-Pacific Partnership now being negotiated, standards that are much higher than what was involved in joining the World Trade Organization. China, however, will need to make major changes to meet these standards, and if the United States makes significant concessions to enable countries such as Vietnam to join, China will probably also push for concessions. ◈

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