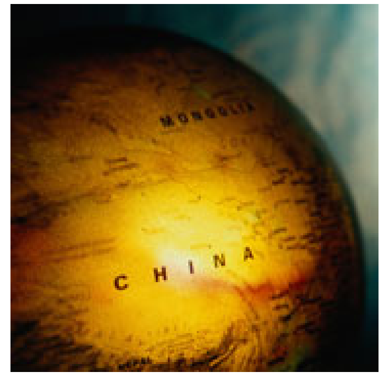
Why China Needs to Grow Its Economy, or Risk Growing Unrest

Published : February 04, 2009 in Knowledge@Wharton



Chinese Premier Wen Jiabao took to the stage at last week's World Economic Forum in Davos, Switzerland, and confidently predicted that China's economy would grow by 8% this year -- the minimum growth that China's leaders say is needed to maintain order and keep everyone employed.

But what if it doesn't hit that target?

According to Wharton management professor Marshall W. Meyer, the worry today is the chain of events that would unfold with the precipitous drop in foreign trade, on which China is disproportionately dependent. As export-dominated cities like Shenzhen and Suzhou cool off, "migratory workers don't have opportunities, remittances stop ... and there's more poverty back home -- that's the source of worry for the central government," Meyer says. "Unrest in China always begins in rural areas."

The gulf between the rich and poor in China is vast, with urban areas having three times the household disposable income as rural regions. A staggering one-half of the 450 million rural residents of working age are migrants employed in jobs away from home, according to Meyer.

China's government reported on February 2 that about 20 million of the 130 million Chinese migrants who were working in urban manufacturing jobs have been forced to return to their rural homes. The government news agency, Xinhua, reported on January 6 that 2009 was expected to be a record year for mass protests. The bottom line is that China has to build "a real domestic economy," says Meyer. The nation can no longer rely on the "the model that worked since 1978."

Reports of clashes between workers and delinquent factory owners have increased in recent months. Millions of migrant workers, too, have gone home for Chinese New Year and the ongoing Spring Festival -- with no jobs to return to in more prosperous cities.

Some economists forecast China's GDP to grow just 4% to 7% this year. An indicator of the slowdown: electricity production. Meyer notes that it fell 8% in the fourth quarter of 2008 versus the same time a year before. "Factories have slowed down" significantly, he says.

'Imponderables are Huge'

Penn law professor Jacques DeLisle, an expert on contemporary Chinese politics, says that no one knows for sure what will happen if China's growth continues to slow. "The imponderables are huge," states DeLisle, who also teaches at the University's Center for East Asian Studies. "We haven't seen anything like this in decades."

DeLisle suggests that the very legitimacy of China's leaders is at stake. "The regime has so hitched its wagon to rapidly rising prosperity that it, in fact, has to do better than most governments." But even as discontent rises, "this is not a regime at risk of being toppled." He believes Chinese leaders will use carrot-and-stick tactics to keep order -- "a judicious mix of making transfer payments to quell discontent, and cracking down on uprisings or political opposition that is gaining speed."

"It's easy for the [Chinese] government to control the news and deflect criticism," says Wharton finance professor Jeremy J. Siegel. "They can say that the global crisis was triggered by irresponsible financiers in the U.S., and that it's beyond our control, even though we're doing all we can to minimize the impact."

Siegel is hopeful that a turnaround may begin in the second half of this year, and he predicts that the Chinese economy will gain speed quickly as Western consumers -- especially in the U.S. -- return to stores in search of cheap goods. "Markets are linked, economies are linked. We're all in the same boat."

China's government has been successful in the past at diverting resources "to assure that the level of unhappiness is kept to a low boil," says Avery Goldstein, a Penn political science professor. He believes the Chinese regime already has sent out an order that state-owned industries cannot lay off workers and that the government also has the authority to order banks to lend.

A $585 billion stimulus package, with contributions from local governments expected to triple or quadruple that number, has already been announced by the central government. "They are betting everything on this," Meyer says of the initiative. "The aim is to fund infrastructure -- including railways, social security, medical care, education -- but mostly infrastructure. Whether the money will be spent, or spent as intended, remains to be determined."

Observers agree that the fall-off in world trade only underscores the urgent need for China to lessen its dependency on trade and build up domestic demand. "The Chinese dependence on exports is not sustainable in the long run," according to Meyer. China's overall trade ratio -- imports plus exports divided by GDP -- is 70%, compared to about 25% to 35% for the United States, Japan and the European Union, he notes.

Meyer sees two employment problems in China: displaced peasant workers and, to a lesser extent, unemployed college graduates. Roughly a quarter of last June's six million college graduates remain unemployed, he says. About one-third of rural migrants live more or less permanently in coastal cities, with the other two-thirds constantly on the move for work. The economic slowdown is "devastating" on rural areas since a factory wage on the coast normally supports three or more people back home. "As demand for Chinese exports drops, peasant workers buy one-way tickets to home and unemployment. The first priority of the central government is to put these people to work before they become restive and uncontrollable," Meyer says.

Prodding the Spendthrifts

But kick-starting the Chinese economy requires people to spend, and that's a big part of the problem. Some local governments are going so far as to simply hand out shopping vouchers, according to Meyer. Last December, the Chengdu government in earthquake-ravaged Sichuan province gave away vouchers worth 100 yuan (or about $14.70) to 380,000 people.

DeLisle believes the real barrier to raising domestic demand is over-saving by Chinese workers, who sock away about 40% of their income because of the absence of a reliable safety net for social security or healthcare. "Until the government can get people to start spending income, there will be limits to increasing domestic demand. What they really need is consumer demand, which will remain weak as long as people feel compelled to save at a high rate."

China is in the process of building a better social safety net, DeLisle adds, but "it's a very, very big project and nowhere near complete. Confidence that it will come together is not high among the populace." Meyer agrees that a stronger safety net would encourage spending. "However, peasant workers don't want to contribute to social security, required under the new Labor Contract Law. Why? Social security is administered by provincial rather than central authorities. Peasant workers know they won't get their money back. The same holds for medical insurance."

China has a household registration system with a "hukou" permit that ties every family to one place. Migrants moving around the country would pay into a regional fund, but not reap the benefits. "No hukou, no benefits," Meyer says.

"The bottom line," according to Meyer, "is that employing people takes priority over everything, and the central government has not yet addressed the issue of creating sustainable domestic markets." Spending on rural infrastructure would help, he says. "But the real problem is the preponderance of small, local businesses, the logistics nightmare created by industry fragmentation, and the reluctance of government to permit private enterprises to grow beyond a point."

