# 6. Two Major Problems Confronting China: One Hard, the Other Harder

AMONG THE MAJOR ECONOMIC PROBLEMS confronting China, two are particularly difficult. The problem that has lately received the most attention and concern is actually the less difficult of the two. The second not only is more difficult but also has been largely ignored in public discussion.

The easier problem is the so-called overheated Chinese economy and the worry that the "bubble" may burst, with serious consequences for Asia and the world economy.

China has achieved and sustained a remarkably rapid rate of economic growth—9.2 percent in 2003 and an annual rate of 9.7 percent in the first quarter of 2004. Along with rapid GDP growth have come various indicators of overheating, including a 3.5 percent increase in the consumer price index in the first quarter of 2004 on a year-over-year basis, a 20 percent rise in the money supply in 2003 partly due to foreign capital inflow, and a $30 billion jump in China's foreign exchange reserves.

At China's Boao economic forum in April, President Hu Jin-

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tao explicitly acknowledged the overheating problem but expressed confidence that it can be controlled and a "hard landing" avoided. There are reasonably strong grounds for his confidence. Awareness of the problem by China's top policymakers is an encouraging sign, as is their recognition of the various policy instruments they can employ in a timely manner to forestall and mitigate the problem. These instruments include raising interest rates, boosting capital and reserve requirements in the four main state banks, and installing and enforcing more-rigorous standards of risk assessment for bank lending under the guidance of China's Banking Regulatory Commission.

China's monetary policymakers are reluctant to push these instruments too hard lest they overshoot and, in the process, precipitate a sharp fall in the economy's performance. Instead, curbs have been imposed on bank lending in certain overheated sectors, including steel and automobile production. These modest, piecemeal efforts seem to be having a cooling effect: growth both in the money supply and in bank lending has been lowered by 2 or 3 percent in the past few months, although consumer prices continue to rise. In any event, if the limited measures invoked thus far turn out to be insufficient, prudent use of the other policy instruments should enable the brakes to be applied without producing a hard landing. Although China isn't out of the woods yet with its overheated economy, the problem appears manageable.

The problem that is more difficult to resolve springs from a dilemma presented by two economic objectives, both of which are of crucial importance for China's future: (1) sustaining a high rate of economic growth and (2) generating ample job opportunities for large numbers of unemployed and underemployed workers. For political and social as well as economic reasons, achieving a high rate of job creation is no less important than is sustaining a high rate of GDP growth.

Although the two objectives are usually viewed as compatible and even mutually reinforcing, there is a fundamental tension arising between them because of the two-sided effects of rising labor productivity.

GDP growth is enhanced by boosting labor productivity, but the employment-generating effects of GDP growth, per unit of growth, are *lowered* as labor productivity rises. Stated another way, increased labor productivity—defined as output per worker or per hour of labor—is of central importance in propelling economic growth, but, the more rapidly labor productivity increases, the less new employment is created by economic growth.

According to conventional wisdom, China's huge (1.3 billion) population provides a virtually inexhaustible supply of low-cost labor that, along with more-globalized markets, presents strong competitive challenges to industries and firms in other countries. What is less well recognized is that globalization also creates a serious challenge for China and its policymakers. For China to sustain a high rate of economic growth, it must combine labor with technology, management, design, and marketing, as well as capital. The effect of this combination will be to raise the productivity of labor substantially and continually, thus reducing significantly the added employment generated by economic growth.

The rate of increase in employment is precisely equal to the difference between the rate of GDP growth and the rate of growth in labor productivity. If and as labor productivity rises, generating a specified number of additional jobs requires a still higher rate of GDP growth.

During the four-year interval between the end of 1998 and the end of 2002, China's GDP rose from 7.8 trillion yuan ($946 billion) to 10.6 trillion yuan ($1.28 trillion), in constant prices, an annual increase of 7.8 percent. During the same interval, labor productivity rose from 11,100 yuan to 14,380 yuan per worker, an annual rate of increase of more than 6.7 percent. According to China's official statistics, employment during the four-year period rose to 737 million from 706 million, an annual increase of 1 percent.

Thus, whereas China's economy was growing at the highest annual growth rate (7.8 percent) of any of the world's principal economies, its increase in employment was only 1 percent annually.

China's employment problem is even more serious than these numbers suggest. Notwithstanding the reported increase in total employment of 31 million between 1998 and 2002, registered urban unemployment increased to 4 percent from 3 percent—to 10 million from 6.7 million—whereas urban employment was growing to 248 million from 224 million. Thus, the number of new urban jobs was 10 million less than the number of workers seeking them.

These numbers are only the tip of the unemployment iceberg. Research by RAND indicates that, when proper allowance is made for "disguised" rural unemployment as well as "unregistered" urban unemployment, China's actual unemployment rate soars to an estimated 23 percent of the total labor force. (The term *disguised* unemployment refers to labor that is reported as nominally employed but in fact does not add to output—in the U.S. labor market, *featherbedding* is the nearly equivalent term.)

The strains and stresses that will result from the persistent masses of China's unemployed and underemployed labor are difficult to assess but hard to overestimate. China's employment problems are a deeper, more long term, and potentially more serious challenge to economic and social stability than is the temporarily high temperature of its economy.

POSTAUDIT

China's overheated economy has cooled a bit, consumer prices have been rising, and its unemployment problems remain acute, as argued in the essay.