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November 24, 2010

# In China, Cultivating the Urge to Splurge

By **DAVID LEONHARDT**

When the Wuqi International Hotel was completed this spring, it immediately dominated the modest skyline of Wuqi, a small city in north central China. The hotel stands 21 stories tall and is wrapped in gleaming gray metal, with two glass elevators running up the outside. On a recent stay there, I had a clear view of the nearby mountains from my 19th-floor room.

The hotel is part of an effort by local officials to reshape their city in ways that many economists, both inside and outside China, have been recommending for the country as a whole. The government of Wuqi (pronounced, roughly, Wu-tzi) offers more generous health insurance to its citizens than many places. Its schools are free all the way through high school, rather than through only ninth grade, as is usual in China, and have been the subject of admiring stories in the Chinese media. Over the last decade, the city has embarked on an ambitious tree-planting program that has brought green to the yellow-brown hills of the Loess Plateau, where Wuqi is located. The Communists ended their Long March in those hills in 1935, and the Wuqi International Hotel is meant to host tourists who come for this history.

The larger idea is to build a more sustainable economy, or what Chinese leaders have called a balanced and harmonious society. In that economy, families would not have to save 20 percent of their income in order to pay for schooling and medical care, as many do now. They would instead be able to afford more of the comforts of modern life — better housing, clothing, transportation and communication. In time, China would become the world's next great consumer society.

That term may have negative connotations in the United States, particularly after the last decade of debt excess. But the term means something very different for China. A Chinese consumer society would improve the lives of hundreds of millions of people. The benefits of the industrial boom that began in the 1980s would spread more rapidly beyond the country's eastern coast. The service sector would grow, and the economy would no longer be quite so dependent on smoke-spewing factories.

For the rest of the world, the Chinese consumer is one of the best hopes for future economic growth. In the years ahead, when the United States, Europe and Japan will have no choice but to slow their spending and pay off their debts, China could pick up the slack. Millions of Americans — yes, millions — could end up with jobs that exist, at least in part, to design, make or sell goods and services to China. This possibility helps explain why Democrats, Republicans, economists, business consultants, corporate executives and labor leaders all devote so much time to urging China to consume more. One subtext of the recent G-20 meeting in Seoul was the encouragement of Chinese consumption.

What's striking about Wuqi is just how serious its officials are about making this transition happen — and yet how difficult it nonetheless will be. The Wuqi International Hotel was as comfortable as most Marriotts or Hiltons in the United States, but the surrounding streets had the dusty feel of a backwater. The hardware, liquor and food stores down the block were each the size of a storage closet and about as well lighted. In the evenings, when Wuqi residents gathered in a public square to talk or perform exercises together, many of the stores were closed. The parents I met were thrilled that high school was free but were still saving an enormous portion of their modest incomes to pay for college or a new home. Those savings create a self-reinforcing cycle, in which stores don't flourish because people don't shop much and people don't shop much partly because there aren't many good stores. As Feng Zhendong, Wuqi's reform-minded Communist Party secretary, says, "There's only so much to spend on."

Then there was the hotel itself. During my first night there, I don't think I saw a single other guest — in the lobby, the restaurant, the elevator or on the 19th floor. After I used the hotel gym, the front desk called to ask if I would be using it the next morning as well. In that case, someone would make sure it was unlocked.

No one believes the Chinese economy will transform itself overnight. But how long will it take and how difficult will it be? Preoccupied with our own economic insecurity, Americans may well be underestimating the challenges — and fears — of their new rival.

**The rise of China** can often seem inevitable. It is the world's most populous country, now reclaiming its long-lost power. Its economy recently passed Japan's as the second-biggest in the world, leaving economists to debate whether China was on pace to overtake the United States by the year 2025 or 2030. Yet China's rise has been anything but inevitable. Consider other poor countries — in South America, Africa and even Asia — with vast pools of cheap labor, which nonetheless have not been able to grow rapidly. Or consider other once-socialist countries, mostly in Eastern Europe, still suffering from a post-Soviet hangover. Even look at India, which is often paired with China as the great growth story of modern times. As

recently as 1990, India had a comparable per-capita income to China. Today, China's is more than twice as high. So having a lot of cheap labor or moving toward a market system, or even both, does not guarantee the phenomenal growth China has experienced.

That growth — among the most rapid in human history — has been a result of strategy and good fortune. The Maoist period was brutal and repressive, but despite the terrible famines and the Cultural Revolution's assault on education, China did emerge with an unusually literate and healthy population for a poor country. Toward the end of that period, even before the one-child policy, a baby boom ended, creating a relatively small group of children and elderly to be supported by a large group of able workers. Into this fertile economic ground, [Deng Xiaoping](#) and his fellow reformers planted the seeds of a market evolution. Workers gained an incentive to succeed, while central planners, unconstrained by democracy, made the investments to turn China into the world's factory.

This model is part of something that has been called the Beijing Consensus, and it is understandably appealing to other poor countries. Yet in many respects it is not new. Politics aside, China's story is the classic one of economic development: investments in physical capital and education make a society more productive and are combined with a huge shift of people from farms to factories. England, Germany, the United States, Japan and South Korea have all followed the model over the last 250 years. The economist Gregory Clark, author of "A Farewell to Alms," calls it the only story of economic development.

And this same story explains why China's continued rise is no more inevitable than its recent rise. From far away, China may look like an unstoppable colossus. From the inside, it looks more vulnerable. Indeed, Chinese economists, business executives and Communist Party officials are debating, sometimes passionately, just how vulnerable it is. "In the short and medium term, there should be no problem," says Yu Yongding, a prominent economist. Among other things, the government has built up enough savings to spend its way out of most problems over the next several years. "But there are fundamental contradictions in the Chinese economy. We can waste our strengths in one or two decades. If we exhaust these strengths, then we'll be in a big trouble."

**To continue growing** rapidly, China needs to make the next transition, from sweatshop economy to innovation economy. This transition is the one that has often proved difficult elsewhere. Once a country has turned itself into an export factory, it cannot keep growing by repeating the exercise. It can't move a worker from an inefficient farm to a modern factory more than once. It cannot even retain its industrial might forever. As a country industrializes, workers will demand their share of the bounty, as has started happening in China, and some factories will start moving to poorer countries. Eventually, a rising

economy needs to take two crucial steps: manufacture goods that aren't just cheaper than the competition, but better; and create a thriving domestic market, so that its own consumers can pick up the slack when exports inevitably slow. These steps go hand in hand. Big consumer markets become laboratories where companies know that innovations will be tested and the successful ones richly rewarded. Those products can then expand into countries with less mature consumer markets. Look at the telephone, the personal computer and the iPhone and iPad, all of which were designed in the United States and are now sold around the world.

Today's China cannot claim any such achievement, a fact that weighs on Chinese policymakers. They worry about the country's ability to innovate and, in particular, about the quality of its education system. When I met with Guo Shuqing, a party official and the chairman of China Construction Bank, in his office high above Beijing's financial district, he mentioned that a recent ranking of the world's top 100 universities included 53 from the United States but just three from mainland China. Even those numbers, Guo said, probably overstated the strengths of China's universities: "In terms of innovation — really original, creative ideas — they're very weak," he told me. By contrast, the American education system helped make possible Google and other companies.

Clearly, many of China's weaknesses can be ascribed to its stage of development. Yet there is no iron law that it will reach the next stage. Japan and the Soviet Union, in different ways, both failed to make the transition to an innovation economy. While they may seem like unimpressive comparisons today, they once occupied a position much like China's. They were rising powers that appeared to have found a new model for growth. In a 1994 essay in Foreign Affairs, Paul Krugman, the economist who is now a New York Times columnist, pointed out that Americans were then talking about Japan and the so-called East Asian tigers in ways remarkably similar to how they had talked about the Soviet bloc in the 1960s. "Once upon a time," he wrote, "Western opinion leaders found themselves both impressed and frightened by the extraordinary growth rates achieved by a set of Eastern economies."

The Soviet Union, of course, utterly failed to take the next steps. Japan did nurture some of the world's most successful exporters, like Sony and Toyota, and developed just-in-time manufacturing processes that were widely copied. But its domestic market remains sheltered and inefficient, especially in the service sector, which has held back growth and innovation. Japan has not merely slowed down, as is inevitable when countries get richer; it has become a global symbol of economic mismanagement. These troubles seem directly relevant to China, given that China, too, has protected much of its domestic economy from competition.

The United States, for all of our current problems, is still easily the world's largest economy, which is partly because we made the transition from an industrial economy to a consumer economy. Income in the United States remains about 30 percent higher than in Germany or England on a per-capita basis, 40 percent higher than in Japan and more than six times as high as in China.

China does have advantages that other countries did not, starting with its size. But it still will not find the transition easy. A consumer economy revolves around individual choice, and Beijing's authoritarian government is often hostile to the idea of choice. The government is also filled with many officials who have known only industrial-led growth — and have benefited from it — and who are at least as influential as the economic reformers preaching the virtues of domestic consumption. These reformers will have to persuade their colleagues to step back from the most aggressive industrialization any country has ever undertaken. China now spends about 50 percent of its **gross domestic product** on a broad category economists call investment — roads, bridges, trains, ports, technology, factories and office buildings. That is the highest share in recorded history. During their great booms in the 1960s and '70s, Japan and South Korea never topped 40 percent. China itself was spending 35 percent only a decade ago.

Already, there are signs that China is bumping up against the limits of its industrial revolution. Other countries are frustrated with its growing share of exports and are pressing China to raise the value of its currency, the renminbi. And the demographic wind that has been at China's back is on the verge of switching direction, leaving the country with fewer workers and more retirees. Without a seemingly endless supply of cheap labor, companies will have to raise wages, which — like a higher renminbi — would make Chinese exports less competitive. Even before the demographic trends put pressure on pay, this year's strikes at a Honda plant in Guangdong Province, among other factories, led some companies to lift wages more than 20 percent. Twenty-eight provincial governments increased their minimum wage between 12 percent and 32 percent.

Perhaps the most telling sign that China's economic model is reaching its limits is a decline in its efficiency. To maintain 10 percent annual economic growth, it has had to invest more and more in roads, buildings and the like. In other words, the return on its investments has begun to fall, which is never a good sign. "We've got a problem," Guo, the bank chairman, told me. "We realize this kind of growth is not sustainable. It's not the kind of problem like a **financial crisis**. But if such inefficiencies accumulate for quite a long time, you reach the point where, suddenly, maybe things burst."

During my recent stay in China, I came away, as many Westerners do, awed by the country's accomplishments. Cities have sprouted from nothing, allowing peasants to leap a century of economic history in a decade. Rural areas have highways that are smoother than in many major American cities. One bullet train I took could cover the distance between New York and Washington in an hour. The United States is on course to have such a train approximately never.

But once you start to notice the signs of unsustainability, you start seeing them everywhere. Some highways are strangely empty. So are some buildings. When I tagged along with a group of American businessmen on a tour of what we thought was a new energy-efficient office building in Hangzhou, a coastal city a couple of hours south of Shanghai, we soon realized that it was — hard as such a thing may be to imagine — a sample office building. It had been built to show potential investors what their business might look like if it moved to Hangzhou.

This unsustainability is especially pronounced in the current real estate mania. Housing prices have been soaring, despite government efforts to cool the market. Relative to rents, housing prices in Beijing, Shanghai and Hangzhou are higher than they were in most any American city at the peak of our housing bubble. In Beijing or Shanghai, four or five different real estate agencies might open on a single block. Other agents simply set up shop on the sidewalk, with a table and brochures. At traffic lights in Beijing, young men walk among the idling cars and hand out brochures for newly built apartments.

It is true that an economy growing as rapidly as China's can catch up to many of its excesses. But it will probably need to change to do so. Wages will have to rise faster, and people will have to spend more of their income. Otherwise, many infrastructure projects will end up resembling make-work, and house prices will fall. Banks and the government will then be saddled with bad loans, exhausting the fiscal strength that Yu and other economists see as China's biggest advantage.

None of this means China is on the verge of running out of steam. It probably has at least 5 or 10 years of rapid growth ahead, even if it simply doubles down on its current growth strategy, because it can still take more industrial market share from other countries. In a way, though, the country's short-term strengths in manufacturing and exporting may be another reason to wonder what the future holds. Those strengths will make it harder for China to summon the urgency to remake itself.

**The debate over** economic policy in China feels different from other political debates. People who will not mention the words “Tibet,” “[Falun Gong](#)” or “1989” in polite

conversation talk openly and critically about the state of the economy. The criticism serves party leaders' purposes in some ways, because it tends to underscore that China remains a poor country, unable — in their telling — to reduce pollution or raise the value of the renminbi without causing economic misery for its citizens. The closest thing to a loyalty test in the public discussion of the economy is the renminbi. Chinese economists often harshly criticize the United States for putting pressure on China to appreciate its currency, even if they eventually get around to mentioning that they, too, think it should rise.

Yu, the economist who worries that China has only a decade or two to avoid trouble, qualifies as a moderate reformer. Sixty-two years old, with a mop of graying hair and long, loose sideburns, he is part of the generation that has lived through nearly all of the Communists' time in power. His great-grandparents immigrated to the United States as laborers in the 19th century, but the family eventually returned to China. His father was a journalist, and Yu himself was going to college in Beijing when the Cultural Revolution began in the mid-1960s. Branded an intellectual, he spent 10 years working as a semiskilled laborer at the Beijing Heavy Machinery Factory. "If you were lucky, you went to a factory," he told me. The unlucky students were sent to remote provinces or worse. Still, he refers to his time in the factory as hard labor.

When not on the job, he read voraciously and realized he wanted to become an economist. He is not great at any one thing, he says, but is interested in many, including history and math. Economics seemed like the ideal profession. In 1979, he joined the Chinese Academy of Social Sciences, a research group founded as part of Deng's economic reforms. Except for the six years he spent at Oxford earning his doctorate, he has been at the academy ever since. Stephen Green, a Shanghai-based economist with Standard Chartered, the British bank, calls Yu one of the pioneers who brought statistically rigorous methods to Chinese economics and was willing to follow the evidence wherever it led. This doesn't make Yu a dissident, however. He calls himself quite conservative. "I believe in gradualism," he told me.

China's gradualist approach to economic policy has been a big part of its success. The country avoided the turmoil that some of Eastern Europe experienced when it switched almost overnight to a market system. China has also escaped the fate of old-style centrally planned economies like Cuba's, because Deng and his followers were more pragmatic than ideological. If something worked — if it led to growth and jobs — they usually favored it. As Yu says: "Growth has been the single-most-important objective of Chinese policies for decades. Without growth, there are not enough jobs, and there is instability." To create these jobs, the party has heavily subsidized companies, especially manufacturers that export goods. Some of these subsidies are direct and obvious, like those now benefiting China's clean-energy industry. But most are subtler. Yu ticked off a few:

The government holds down the price of coal, oil and other natural resources, hurting interior provinces that produce these resources to the benefit of coastal exporters that use them. Beijing also sets a ceiling on interest rates, which harms households trying to build a nest egg and helps capital-intensive businesses that borrow to expand. The price of labor is indirectly suppressed, too. Independent unions are illegal, and a household-registration system called *hukou* has long treated many migrants who move from distant provinces to cities to work as if they were illegal immigrants. Basic benefits — free schooling, pension, health insurance — are often unavailable to people who work outside their native regions.

The renminbi falls into the same category. By buying large amounts of [United States Treasury](#) bonds (and, to a lesser extent, Japanese and European bonds), China has kept its currency artificially low. The renminbi has roughly the same value today as it did in 1990, relative to a basket of other currencies, which is remarkable considering how much faster China's economy has grown than the world economy. The low renminbi holds down the price of Chinese-made goods in other countries, increasing exports. But it also means that foreign-made products are more expensive within China than they would otherwise be. In effect, China's government is deliberately reducing the buying power of its own consumers to subsidize its exporters.

On the currency, Yu takes the typical stance for a reform-oriented economist. "For the sake of China, I am a strong supporter of renminbi appreciation," he told me. On the other hand, he is angered by Americans who argue that the exchange rate damages the United States. "That's total rubbish," he says. "The problem is not between China and the United States. The problem is between American companies that invest in China and American workers within the United States." This analysis may overstate the case; because exports are a larger part of China's economy than imports, it does seem to benefit on net from the low renminbi. But Yu is certainly correct that Western companies with a large presence inside China — a long and influential list — also benefit from the low renminbi. American workers who have lost their jobs to outsourcing do not.

**On a September afternoon,** Yu and I were sitting in the living room of a hotel suite on the outskirts of Beijing. He lives in the city with his wife, but he was staying at the hotel for a few nights to attend a conference for American and Chinese economists called the Summer Palace Dialogue. The Summer Palace was the emperor's country retreat, and the resort where the economists were staying tried to combine ancient grandeur with five-star amenities. "I don't like this," Yu said, gesturing around the room with its finely appointed furniture. "It is too much. It is not necessary." Such excess, he noted, "is a problem with China's political system."

The subsidies that China showers on its corporate sector have been crucial to building an industrial economy. But they have also led to a severe concentration of income. Some of it takes a form Americans are used to: the rich receive a much larger share of the national income than they did a few decades ago. Forbes reported early this year that mainland China and Hong Kong had 89 billionaires. Japan, with an economy almost as large as China's and per-capita income several times higher, had just 22. Shanghai now has three of its own Louis Vuitton stores.

In addition to the high degree of income concentration, China has another kind of inequality. All the corporate subsidies have allowed companies to accumulate enormous profits, and a corporation's gains and losses ultimately flow to individuals. In China, today's huge profits mostly benefit the well-off, be they executives, investors or party officials. The well-off not only have much higher take-home pay than the rank-and-file but also tend to be the ones who have access to the benefits of hoarded corporate cash. Many of the new Audi and Buick sedans on the streets — China's versions of the Lincoln Town Car — are company cars, and many of the guests at the Summer Palace resort are on expense accounts. State-owned companies have done especially well, even in resource industries where the price of their products is kept artificially low. Huang Yiping, an economist who previously worked at Citigroup, points out that state-owned banks tend to have much grander office buildings than their private, generally foreign rivals. In Wuqi, the only building that compares with the new hotel is another hotel owned by the local oil company.

Yet despite the long boom, most Chinese citizens remain fairly poor. Per-capita G.D.P. is about \$7,000, and consumption makes up only 35 percent of the economy, thanks to the high levels of savings and corporate profits. So per-capita consumption — the amount of money the average person spends — is only about \$2,500 a year. In the United States, by comparison, it is about \$30,000. In Brazil, where per-capita G.D.P. is one and a half times that of China's, consumption is more than two and a half times as high, or about \$7,000.

Of course, anyone who has lived through the global bubble and bust of the last few years may wonder what's so great about a consumer society. In the United States, the idea that we have reoriented our economy toward consumption and don't make things anymore has become a standard lament, not a sign of progress. But China is a long way from consuming too much. Saying that China does not have a big-enough consumer economy is really another way of saying that not enough of its resources reach the broad mass of its people. If they had more resources, they would surely spend more. This is why the recent labor strikes, and the pay increases that followed, were so important. They were a sign that Chinese households might start to enjoy more of the fruits of the long boom.

In coming years, the pressure to raise wages will increase. The size of China's labor force, relative to the rest of its population, will peak in the next few years, if it hasn't already. The country is still a long way from facing labor shortages, but the flow of young workers from the countryside will slow. Companies will probably have to respond by raising wages of their existing workers or by moving inland, where wages are lower, and paying workers there what they once paid workers on the coast. Either way, the effect will be to raise the average wage nationwide. Foxconn, which employs 920,000 people making iPhones and other technology products, is opening new factories in Chongqing, a large city 1,000 miles inland.

Given that China is not exactly a free-market economy, the extent to which wages rise will depend in no small part on government policy. Party officials are themselves torn over what to do. One businessman told me he knew that most outsiders thought of China as a top-down, centralized country. "But China is a collection of special interests," he said, "like the U.S." Leaders understand that suppressing labor unrest may help economic growth in the short term by holding down wages and thus the price of exports. But many also know that economic discontent risks political instability of the kind that in the last century alone toppled an emperor and Chiang Kai-shek, led to the chaos of the Cultural Revolution and threatened the current regime in Tiananmen Square.

Yu finds the allocation of resources to be perhaps the most frustrating aspect of today's economy. Even as companies and the largest cities are prospering, many parts of society are starved of resources. Last year, Yu's wife spent part of the summer tutoring the daughter of the woman who cleans their building. The girl was moving from her hometown to live with her mother in Beijing and needed to learn English to keep up with her new classmates. The rural school she came from did not teach English. (Her family also had to pay tuition, because the *hukou* household-registration system denied them free education outside their home province.) In some rural areas, the teachers themselves have not graduated from high school. As part of a lecture he recently gave, Yu included some photographs among the usual economic charts and graphs. One showed students at their desks in a rural classroom, surrounded by muddy puddles on a dirt floor. Others showed the spectacular new Beijing Opera House, a bullet train and a series of gaudy provincial government buildings.

It is worth pausing for a minute on this contrast. In the big cities of the coast, the creation of a Chinese consumer society is proceeding apace. Sometimes, it can even seem a step ahead of the United States. On the tunnel walls between some stops of the Beijing subway, video advertisements move at the same speed as the train, vying for riders' attention with televisions, also showing ads, inside the subway cars. Modern Chinese society hardly seems hostile to the idea of consumption. The problem is how little money so many people have.

**Wuqi has been** able to try a different economic model because it is neither too rich nor too poor. Located in Shaanxi Province, about a third of the way west from Beijing toward Tibet, it is too remote to be a factory boomtown. Indeed, it can feel more like part of China's past than its future. The billboards lining the mountain roads into Wuqi display Communist Party sayings like "Support the military, and the military should love the people." The older homes in the area are the same kind as those in which Mao and his comrades lived during their Shaanxi exile: mountainside caves, fronted by a stone archway and facade. But Wuqi also has oil. Feng, the party secretary, has decided to spend a large portion of the oil money on education.

Growing up in a farmer's family in Shaanxi, Feng was the sixth child of seven, and the only one to go to college. When I asked him why, he said his family could not afford to send more than one child and decided he was the most clever. Most of his siblings are now farmers or laborers. Feng became a hydro-engineer at a state-owned company until the party told him to go into government. Today, at 44, he travels around Wuqi in a government-issued white Toyota Land Cruiser, frequently checking e-mail on his Coolpad smartphone.

Many of the teachers Feng had growing up were unqualified. As party secretary, he has closed more than 100 village schools and built new, centralized ones. Students as young as 6 spend Sunday through Thursday nights in brightly colored dormitory rooms that, like many newer local houses, have archways evoking the caves. Wuqi has also raided other cities to hire well-regarded teachers, sometimes offering annual salaries equivalent to \$30,000, which is several times what a locally hired teacher makes.

In some ways, Wuqi's schools are impressive. Feng made sure a new preschool was built in advance of a neighboring low-income apartment complex, so that children who moved in would immediately be able to enroll. The steps of an elementary school I visited were painted with American sayings to help students learn (like "That's all!" and, oddly, "I'm on a diet"). A middle school had a 2,500-seat sports stadium. At one Wuqi high school, uniformed students walked down a hallway beneath photographs of [Amherst College](#) and N.Y.U. In other ways, though, the schools have a long way to go. Every high-school class I saw, for instance, had more than 50 students. The fairest conclusion seemed to be that Wuqi's schools were improving and that local party leaders were serious about continuing to improve them.

Education has already played an underappreciated role in China's rise. For decades, Chinese children have spent more years in school than their peers in other countries; among the world's many cheap laborers, China's have been uncommonly skilled. As Arthur Kroeber,

editor of the China Economic Quarterly, says, “You can have a lot of cheap labor, but if that cheap labor can’t read, can’t follow instructions and is sick all the time, it doesn’t help you.”

The next step is to educate people not just for factory work but for the white-collar work that would be a growing part of a consumer economy. Much of that work requires a full high-school education, if not college too. Today 55 percent of China’s adult population has graduated from high school (compared with less than 10 percent in India). But only about 5 percent of Chinese adults have a college degree of some kind.

The uneven quality of China’s colleges presents one problem. A recent book coined the term “ant tribe” to describe the many struggling recent graduates, particularly of second- and third-tier colleges. Over the long term, the bigger problem is that education beyond junior high school is financially out of reach to many families. In most parts of China, tuition starts when children are about 14. In a recent poll, Chinese families cited education as the main reason that they save money.

Even in Wuqi, many parents, thinking ahead to college, worry about being able to afford their children’s education. On a drizzly Tuesday in September, just before the start of the Mid-Autumn Festival holiday, I talked with a woman named Guo Xiuqin while she and her twin 4-year-old daughters waited outside a preschool for another child they were taking home. Guo, wearing a simple leather jacket, described how Wuqi had changed in recent years. “The new houses are so different, with tiles and bricks and new colors,” she said. Farmers are no longer tied to their land, thanks in part to a local program that gives them money to plant trees on it instead. Her husband spends most of his time on the road, running a small transportation business. In all, the family makes about \$8,000 a year, and the free preschool has allowed them to increase savings. Guo guessed they now saved about half their income. “College will cost a lot of money,” she said, and she wants her daughters to go as far in school as they are able.

The rest of their income pays for food and clothing and to take care of elderly parents. I asked if there was anything Guo, who is 30, hoped to be able to buy in the future. “I don’t want anything,” she said. What about an apartment in the village, closer to the school, rather than in the countryside? “Of course,” she replied, smiling, “but how could I possibly dream of that?”

**If China does** ultimately build a consumer economy, it will probably depend more on Guo’s daughters than on Guo herself. Today’s teenagers were born after the Tiananmen massacre and have known nothing but boom times, and they may have a different attitude toward spending than their parents. For one thing, teenagers are surprisingly heavy users of

technology, given China's income level. A recent study by the Boston Consulting Group found that people in China spent more time online and were more likely to buy goods online than people in any other large developing country, even richer ones, like Brazil and Russia. The study also found that in rural China, nearly half of all Internet users were under 20. Nearly 80 percent were under 30.

In Wuqi, Internet service works quite well, and personal computers have become common in the last few years. "All my colleagues shop online," says Ma Jingye, 24, who works for the county government. She was using the Internet regularly while she was going to college in Beijing, and when she returned to Wuqi this summer, she was surprised to find it had caught on there, too. Ma said she spent about 200 to 300 renminbi a month, which translates into roughly \$30 to \$45, shopping on Taobao, China's version of Amazon.

Taobao makes for a nice example of the symbiotic relationship between consumption and innovation. Its parent company, [Alibaba](#), which is based in Hangzhou, has grown to be one of the world's most valuable Internet companies, as have two other Chinese companies — Tencent, an instant-messaging service, and Baidu, a search engine. They have been able to grow so large because of China's high Internet usage and because the industry, unlike many others in the service sector, is not dominated by powerful state-owned firms. Internet companies succeed by providing good service at a reasonable price.

But Chinese Internet companies are still a long way from being as innovative as American or European ones. Taobao, Tencent and Baidu do little that Western companies do not. The Chinese companies have succeeded by copying innovations from elsewhere and then executing them well in their home market. Many of today's start-ups are trying to follow the same business strategy. At Innovation Works, an incubator in Beijing founded by Lee Kai-Fu, the former head of Google's China division, fresh-faced entrepreneurs work long hours in adjoining cubicles trying to create the next Taobao. They are charmingly honest about the fact that they are not on the cutting edge. One engineer at Innovation Works explained to me that success didn't yet require innovation. The Chinese market is still hungry for the basics.

The dynamic is at work in industry after industry. One of the nicer stores in Wuqi is a small one run by Li Ning, a top Chinese sneaker and sporting-goods company. It resembles the kind of small sneaker store you might find in a low-end American mall. Even Li Ning's logo, on its products and on the front of the store, is familiar. It is a modified Nike swoosh.

In addition to the immature consumer market, China's education system also holds back innovation. Party leaders, from Feng to the highest levels in Beijing, worry that schools have not yet figured out how to create entrepreneurs who can build great businesses. "The

traditional education produces a problem,” Feng said, “in which people can do well in exams but don’t have very innovative skills.” To address the problem, Wuqi has added more art and music to the curriculum, on top of the usual math, Chinese and English. The high school with the Amherst and N.Y.U. photos on the wall has created clubs for handicrafts, physics, chemistry and singing. Feng admits he does not yet know how well the efforts are working.

Still, you can see how China’s new entrepreneurs might begin to emerge. If schools began producing more innovation-minded students, they could feed off an increase in consumer spending to create products that really were different. If the government opened up more industries — airlines, banking, telecommunications, retail — to greater competition, the fight for customers would encourage innovation there, too. Eventually, ideas for new products might originate in Beijing or Hangzhou or even Wuqi. That would benefit the whole world, just as the world now benefits from American and European innovations. Imagine, say, if China developed a cheap form of clean energy. Above all, innovation would benefit China. Rather than merely having workers making \$1 an hour to put together iPhones, it could also have software developers making \$20 or \$50 an hour to design the next iPhone.

**After a Sichuan dinner** in Wuqi one night — complete with raw hot peppers, dipped in salt, a local way of eating them — Feng asked if I wanted to climb the city’s almost-finished monument to the Long March. The monument starts as a grand outdoor staircase and then becomes a paved path into the mountains, ascending about 1,000 feet over two miles, with scattered statues celebrating workers, peasants and soldiers. From the clearings, I could look down on Wuqi and imagine whether it might conceivably change as much over the next decade as coastal China changed over the last. Would tourists and business executives ultimately fill the new hotel? Would new industries come and stores open? I told Feng that, as impressive as Wuqi’s efforts were, it was hard to see exactly how the city would build a self-sustaining economy in place of one that depended so much on hopeful construction. He did not exactly disagree. “We can’t tell what will be here in 10 years,” he said. “All I can do right now is build up Wuqi’s environment and infrastructure and talent pool, for when the opportunity comes. We can only lay the foundation. It won’t necessarily go as I plan.”

Feng, of course, is not a typical local leader. In many other cities and provinces, the party has pursued short-term growth regardless of the long-term consequences. The party evaluates and promotes officials in large measure based on G.D.P. statistics and not on measures of education, employment or living standards. No wonder, then, that despite all the reform talk from Prime Minister [Wen Jiabao](#) and President [Hu Jintao](#), consumption has continued to be a smaller part of the economy, and investment a larger one, since they took office in 2003.

Nonetheless, there are reasons to believe that China is starting to change and that today's reformers will ultimately win out, just as Deng did in his time. Economic growth in poorer provinces like Shaanxi has been somewhat faster over the last three years than in the richest areas, like Beijing and Shanghai, according to the [University of Michigan's China Data Center](#). For many years, the reverse was true, and the gap was widening. Many provinces are also relaxing the *hukou* household-registration system. Looking ahead, party officials have indicated that their next five-year plan, China's 12th, to be released in March, will focus on the quality of economic growth — how it affects people's lives — rather than the quantity. China watchers inside and outside the country are now trying to figure out how much [Xi Jinping](#), who is likely to become president in 2013, truly supports reform.

The centerpiece of the government's recent efforts to transform China's economy was the stimulus program announced in 2008. Relative to the size of the economy, the stimulus was more than twice as large as America's. It focused on infrastructure, mostly highways, trains and housing. Infrastructure spending is heavy-duty investment that plays off China's existing strengths. When tens of millions of workers were losing their factory jobs at the depths of the global [recession](#), the government was able to put many of them back to work quickly on construction projects. (In an authoritarian state that does not have to worry much about property rights or environmental laws, shovel-ready projects are easy enough to find.) "The government does not have as strong instruments to influence consumption," as Yu says. "Investment is easier." That is especially true in a consumer economy as immature as China's.

But infrastructure can also help to foster a consumer economy. The new apartment buildings going up in hundreds of cities will employ workers now and will later become homes for rural migrants. Once in the cities, those migrants will be able to earn more and spend more. The new train lines and highways will reduce commutes and help stitch together China's domestic economy, much as the Interstate System of highways did in the United States. While I was in Hangzhou, officials there were getting ready to open a new train line that would cut travel time to Shanghai, which is 120 miles away, to less than an hour. "When it opens," Tu Dongdong, a deputy mayor, said, "Hangzhou will become part of Shanghai." Some of the new highways may be empty, but Kroeber, the editor of the *China Economic Quarterly*, said the high-speed trains are mostly full.

Pessimists argue that China has only a few years to start making major changes. According to this line of thinking, the recent splurge on infrastructure will lead mostly to empty buildings and unrecoverable loans, and the weak global economy will soon cause other countries to put up trade barriers unless China raises the value of the renminbi. Optimists reply that China remains a poor country and still has a couple of decades to switch from a

factory economy to a consumer economy. Guo, the party leader and bank chairman, said that he did not think change had come quickly enough in recent years. But, he added, “I think we have plenty of time, plenty of tools and plenty of instruments to make a soft landing and a smooth transformation.” Arthur Kroeber, who agrees, points out that China’s per-capita income is still only where Japan’s was in the mid-1960s.

One reason for optimism is that a version of the current strategy, what Guo calls “build first,” has worked before. Deng and the other post-Mao leaders built the coastal cities before they had been established as manufacturing hubs. They plowed ahead, and China’s natural advantages — size, location, literate population and, hard as it may be to quantify, Confucian work ethic — allowed the strategy to pay off. If that happens again, not all of today’s buildings and roads will be filled, but enough of them will be.

Kroeber first visited China in 1985 during the early stages of both Deng’s reforms and the boom that has continued almost without interruption since. Even then, Kroeber said, he had a hard time imagining that China would find a way to make use of all of its new construction. During that visit, he would sometimes get around Beijing by biking on the recently built Second Ring Road, which encircled downtown. The road was big and wide, with few cars on it, and Kroeber remembers thinking it absurd that the city had spent the money to build it. Today, however, Second Ring Road is clogged with cars day and night. The subway is usually a faster way to travel. Third and Fourth Ring Roads are clogged, too. Fifth Ring Road, completed in 2003, and Sixth Ring Road, completed last year, are less congested. But you would not want to ride your bike on them.

In China’s halting efforts to build a new economy today, there is an intriguing parallel to the United States: Both the world’s largest economy and its latest challenger need to remake themselves. As Guo bluntly told me, “You are facing transformation, too.” The United States needs to shift away from debt-financed consumption with little long-term benefit and toward investments that can create good-paying jobs, like education, infrastructure, energy and scientific research. China needs to invest less and consume more — to keep growing rapidly and, in the process, to stimulate economic growth around the world. In both countries, significant changes are necessary to create more sustainable growth. And in both countries, they inspire fierce internal opposition.

We tend to think of the United States and China as rivals, and they will continue to compete in coming years, over which will build the industries of the future and which will be the dominant power in Asia and the world. But our problems are also linked, just as the Chinese export boom and the American consumption boom depended on each other and, together, helped create the financial crisis. The worst outcome now, for both countries, might well be

economic stagnation in China. That would slow U.S. growth and could lead to political chaos in China. The best outcome would be for both countries to reshape their economies gradually, benefiting both. In neither country will it be easy.

*David Leonhardt is an economics columnist for The Times and a staff writer for the magazine.*