The Insight Bureau

From the Desk of...

Dr. Yuwa Hedrick-Wong
Asia Economist & Business Strategist

Issue No.36 - February 2009

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Dr Yuwa Hedrick-Wong looks at a post-Crisis China: the myths and realities of China's saving and consumption dynamics

The global imbalance of saving

One of the frequently-cited structural causes of the economic crisis is that of the global imbalance between over-consumption (under-saving) in the US (and to a lesser extent, the UK and other wealthy economies) and the over-saving (under-consumption) in emerging markets, most notably China.

Capital inflows certainly lowered interest rates, bid up government bonds and allowed US households to increase their borrowing, and to do so cheaply. This may not have been problematic had it been used to finance productive investment that generated future returns to repay the foreign savers/lenders. However, since 2002 much of this has been used to fund the housing sector boom. In the aftermath of the dot com bust, US business investment was weak. While foreign savers/lenders put more and more of their funds into the US, the demand for investment-grade assets surged, outstripping supply. Financial engineering performed its pivotal role, turning marginal home loans into "safe" investment-grade assets which were then sold, and resold, worldwide … the rest, as they say, is history!

So China has been fingered as having played a major role in this global imbalance by supplying capital to the US with its massive savings. So, to redress the global imbalance, therefore, China is called upon to reduce its over-saving.

The myth and reality of China's savings

China's massive (and rising) savings is indeed a fact. Steadily rising from 37% in 2000 to over 53% in 2007, this has led to one of the most persistent and frequently repeated myths that Chinese households are not consuming enough. True, private household consumption as a percentage of GDP has indeed been shrinking over the past decade. In 1980, when economic reforms had just started, private household consumption was 68% of GDP (a much smaller GDP then, of course) and by 2007, this had dropped to 47% (albeit a very much bigger GDP).

A variety of reasons have been put forward purporting to explain why Chinese households are "under-consuming"; the lack of a well-developed social safety net; the social and economic dislocation caused by structural reforms (e.g. downsizing and privatisation of the state sector in the 1990s); the one-child policy, with parents keen to have extra funds on hand to pay for private tuition and to pay for better quality

private health care if needed. There is, therefore, a kitchen sink's worth of truths, half-truths and untruths surrounding the issue of household savings in China.

To be clear, private household consumption in China has been growing in absolute terms, as the table below shows, household consumption averaged 10.7% p.a. between 2001-2007 but investment grew even faster, averaging 17.6% p.a., over the same period. The difference in these rates has "squeezed" the GDP share of household consumption, reducing it steadily from 68% in 1980 to 47% in 2007.

Growth of Household Consumption versus Gross Fixed Capital Formation (Investment)

Year-on-Year Growth	Household Consumption	Gross Fixed Capital Formation
2001	7.3%	11.6%
2002	6.8%	15.6%
2003	8.1%	22.6%
2004	12.3%	21.7%
2005	11.6%	18.7%
2006	13.0%	16.6%
2007	15.9%	16.7%
Average	10.7%	17.6%

(Source: National Bureau of Statistics)

China's eager consumers

Chinese consumers are ready and eager for new consumption opportunities. Apart from private condos and consumer electronics, private car ownership was one of the new, exciting and lifestyle-changing expenditures that Chinese consumers embraced with great enthusiasm, from a meager 600,000 units in 2000 to 4.9 million in 2007 -- an impressive growth of 38.7% p.a.

The reality is that Chinese consumers do not save any more than their counterparts in Asia Pacific. Indeed, when they save, they do so more to invest or to buy property, as opposed to saving for their retirement. In fact, Chinese consumers have been willing to spend as much as their incomes allow. The shrinkage of private consumption as a share of GDP in recent years is a reflection of the sad truth that wages as a share of GDP have also dropped, from about 53% of GDP in 1998 (in the immediate aftermath of the Asian crisis) down to about 40% by 2007.

So how did this come about? The shrinking share of wages is especially puzzling in light of the significant slowing of labour supply in recent years. Labour supply grew by an average of about 1% p.a. between 2001 and 2006 and has slowed today to 0.4% and projected to shrink by about 0.2% p.a. during the 2011 to 2016 period. Such a trend hardly suggests over-supply of labour to be a factor in suppressing wage growth. Clearly something else is at work. It turns out that culprit is not on the supply-side of labour, but on the demand-side.

An underlying reason for slow wage growth and consumption is China's extraordinarily low interest rates. Over an extended period this distorted the relative prices of capital versus labour. With capital being so cheap, companies started to invest in capital intensive production capacity, moving up the technology ladder faster than they would have done otherwise. In the manufacturing sector, this development was further encouraged

by the widespread availability of export subsidies, making it even more profitable to invest in export-oriented and capital intensive industries.

Although we would usually see a direct correlation between per capita income and an economy's export composition, China stands out as an astonishing exception to this rule, in spite of its reputation as the "factory of the world". It has been estimated that China's exports resemble that of a country with a per capita income of around US$12,000, instead of its actual level of around US$2,500! This shows the extent to which the distorted pricing of capital and labour has affected China's exports, and in the process suppressed the demand for labour, thereby keeping wage growth lower than it would otherwise be.

The reality is that Chinese consumers do not save any more than their counterparts in Asia-Pacific … the business sector is the big saver, not households

Who is behind China's high level of savings and why?

If Chinese households are not over-saving, then who is contributing to the overall high savings, which reached over 52% of GDP in 2007? An analysis of the flow of funds at the macro level pinpoints the business sector as the big saver, not households, reaching 32% of GDP in 2007. In contrast, household savings has been largely stable, hovering around 18% of GDP in the past four years.

Businesses save by retaining their profits. But how do businesses have so much profit to enable them to save so much in China? It is part of the quirky legacy of China's state sector dominance of the past and how privatisation had proceeded in the 1990s. When the Chinese government started to downsize the state sector and reform the poorly-run and loss-making state-owned enterprises (SOEs), the primary concern then was how to ensure that the newly reformed and down-sized SOEs could compete and survive in an increasingly competitive market – i.e. they were seen as weak under-dogs which needed support in order to survive. As a result, SOEs are not required to pay dividends to their (government) shareholders. SOEs operating in the resource extraction sector are not required to pay royalties to the (again government) owners of the resource. All this made sense at the time, when, in 1998 large SOEs collectively made a total loss of over 1% of GDP.

But much has changed since. Strong economic growth has allowed many of the SOEs to turn from loss-making into profit-making entities. The upswing of commodities in the 2004 to 2007 period further allowed many resource sector SOEs (mostly operating as de facto monopolies) to enjoy massive windfall profits as well. In 2007, it is estimated that the combined profits of large SOEs amounted to around 4% of GDP. It is this high level of profit that enabled the SOEs to save so massively. With artificially low costs of capital, these SOEs were also motivated to invest heavily in capital and technology-intensive production facilities, better equipped to compete overseas and to ride the exports boom.

Implications: fiscal spending and post-crisis growth

So this analysis strongly suggests that Chinese households are not under-consuming after all -- they have been spending as much as they could, given their incomes. This is a critically important point to understand at this time, since so much now hinges on China's domestic demand holding up amidst the global economic turmoil. China's

households are not in a position to boost the growth of domestic demand. For that to happen, their wages would need to grow a lot faster than they are. Given that rural under-employment is still widespread and that as many as one million migrant workers are looking for work in urban areas, raising labour-intensive employment is the right answer. In this regard, the so called "stimulus package" recently announced by the government appears to make good sense. Although we can debate the details of the package, including elements of double counting, the immediate focus on infrastructure construction is the right stopgap measure in generating labour intensive employment. The lion's share will go to construction of highways, secondary roads, improving railways, more airports and the completion of the national power grid, all projects which tend to provide labour-intensive employment and fast to implement.

China needs employment creation, better corporate governance and more market-driven interest rates

These are, however, only stopgap measures. For the longer term, China has to wean itself off an over-reliance on exports. China's leadership appears to be more focused on working out how to achieve that than ever before. This means boosting domestic demand and, for reasons mentioned above, this can only be achieved if there is a more balanced allocation of income between households and businesses. China therefore needs to tackle simultaneously stronger employment creation (leading rising wages as a proportion of GDP), better corporate governance (to reduce the business sector's excess savings and investment) and finally more market-driven interest rates (which better reflect the relative prices of capital and labour.)

Growth in sustained domestic demand will ultimately require China to move away from its current dependency on capital-intensive manufacturing (and thus exports) with the service sector becoming the obvious focus of economic activities. State monopolies will have to be dismantled in many of the key service sectors to allow private competition and investment. Expanding services will see employment and income growth in both labour-intensive as well as high-end professional services. The higher household income that results from this will, in turn, support demand for more such services. Over the long term, this is the only way forward for China.

This article has been edited from an *Insight* report written by Yuwa Hedrick-Wong for MasterCard Worldwide – please click here to download the full report.

About Dr Yuwa Hedrick-Wong and The Insight Bureau

Yuwa Hedrick-Wong chairs and coordinates MasterCard's MasterIntelligence Knowledge Panel, comprising leading economists and business strategists, many of whom are also members of The Insight Bureau's resource network, providing speeches and presentations at business conferences as well as confidential, in-house briefings to senior executives. Based in Singapore, Yuwa Hedrick-Wong is a highly respected global economist and Asia business strategist.

The Insight Bureau provides speaker placements and briefings as a service that helps achieve a better understanding of the world in which we do business and ultimately enables companies to make better business decisions.

www.insightbureau.com **+65-6300-2495** **engage_us@insightbureau.com**

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