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China's consumers aren't ready to drive the economy's growth

NAB Group Economics

With the external pressures on China's economy growing, authorities appear to be fighting the trade war on multiple fronts, including increasing tax rebates for exporters, loosening monetary policy and easing policy constraints on infrastructure developments. The latter is perhaps the biggest surprise, given that a crackdown on unauthorised projects by Beijing – in part an effort to address unsustainable debt at the local government level – was a component of the recent deleveraging program. To return to such an old fashioned form of stimulus points to a lack of progress in China's development – the still limited role of the consumer.

THE SLOW TRANSITION TO CONSUMPTION

Well before 2013's Third Plenum, where President Xi unveiled his reform plan for China's economy and society, it was apparent that the country's growth model was running out of momentum. A key part of the reform plan was to transition the economy away from a growth model centred on investment (and to a lesser extent exports) and move towards a consumption based model.

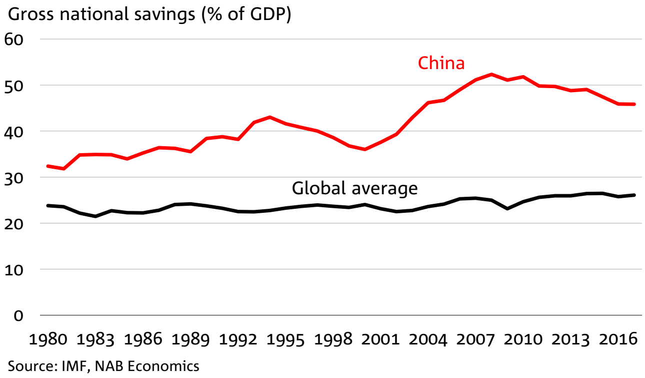
Under the old model, Chinese authorities employed financial repression to limit consumption and direct the large pool of savings into heavy industrial development – essentially following the development path of Japan and South Korea.

This growth model is only effective in the earlier stages of development – with financial repression generally viewed as a negative for longer term growth. As a result, a range of policy changes have been directed towards boosting domestic consumption and slowing investment growth.

That said, progress on this reform has been relatively slow, with China continuing to save instead of spend. Savings (as a percentage of GDP) gradually rose in China between the early 1970s and 2000, but accelerated sharply as the period of rapid industrialisation (post 2000) commenced. Between 2000 and 2010, China's national savings rose from 37% of GDP to almost 52%.

NATIONAL SAVINGS RATE

China's savings far above global trends

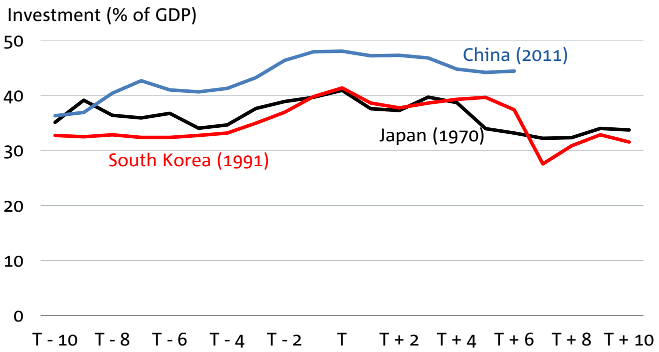


While savings have declined more recently, they remain comparatively high – at 46% in 2017 – a level higher than any point prior to 2005, and one of the highest rates globally.

This large pool of savings has continued to support China's high rates of investment. China's investment share of nominal GDP rose far higher than either Japan or South Korea, peaking at almost 48% in 2011 (compared with their peaks near 40%) and despite a subsequent decline, it remains high (44% in 2017). In comparison, the global average was almost 26% in 2017, and only around 21% in advanced economies.

INVESTMENT LED GROWTH MODEL

China's investment peak larger than peers

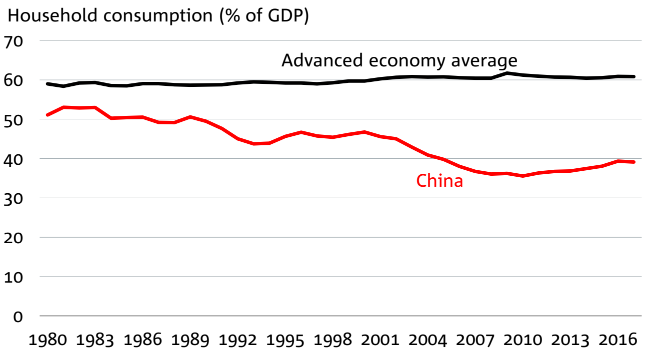


Source: IMF, NAB Economics

Recent trends in retail sales point to a problem for Chinese authorities in attempting to combat US trade measures. China doesn't consume enough – household consumption was only around 39% of GDP in 2017 – and isn't growing fast enough (particularly recently). Real retail sales increased by just 6.6% yoy in August – below the growth rate of the broader economy in Q2 2018 – suggesting that consumers aren't yet ready for a larger role in driving growth.

HOUSEHOLD CONSUMPTION

China's industrialisation came at the expense of its consumers



Source: CEIC, OECD, NAB Economics

WHY HAS CONSUMPTION REMAINED LOW?

There are a range of factors that explain why China's savings rates have remained high, and by extension, why consumption has remained comparatively low. First, China's income and wealth inequality is comparatively high – meaning that the benefits from the country's spectacular growth over the past two decades have not been well distributed.

Second, wages growth has slowed considerably in recent years, limiting the growth potential for consumption. Real disposable income in urban areas has grown less rapidly than the overall economy since early 2015, and a shorter time series shows that median wages growth has grown less rapidly than average wages in recent years – once again pointing towards the inequality problem.

INCOME GROWTH STILL WEAK

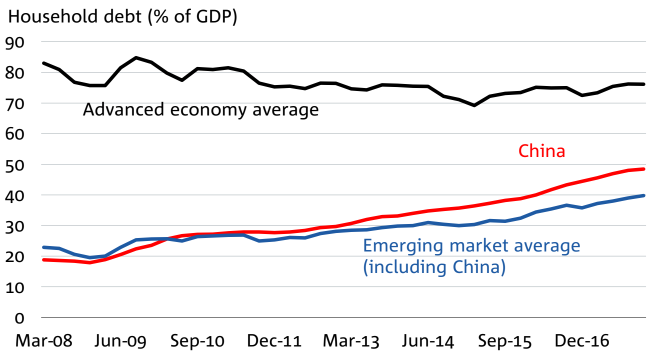
China's investment peak larger than peers

Source: CEIC, NAB Economics

A third factor is the growing stock of household debt. Over the past decade, China's household debt as a percentage of GDP has increased by more than two and a half times to 48%. Although this is not particularly high, when compared with the advanced economy average (76% in Q4 2017), the rapid increase in debt and accompanying service payments will have constrained consumption. Surging house prices are a contributor to this trend – with buyers taking on sizeable debt to afford housing.

CHINA'S HOUSEHOLD DEBT RISING

Rapid increase constraining spending



Source: BIS, NAB Economics

Fourth, demographic changes – following the imposition of the One Child Policy – likely increased the savings rate from the late 1970s onwards. Smaller family sizes meant fewer workers to support older aged residents in retirement, leading to higher savings during their working lives. One recent study estimated that the One Child Policy was responsible for at least 30% of the rise in the household savings rate between 1982 and 2014[1].

This factor is also connected to the fifth factor, which is the breakdown of the social safety net during reforms in the early 1990s. Until this point, social security was frequently tied to employment with a state owned enterprise – the so-called "iron rice bowl". Large scale job losses during this period broke this traditional arrangement, with workers increasing savings to support their own retirement.

CONCLUSIONS – HOW CAN CHINA BOOST ITS CONSUMPTION?

According to the IMF, the key measures to increasing domestic consumption are a strengthening of the social security system, reducing income inequality and increasing household incomes. For the former, this would include large transfers to poorer households as well as boosting expenditure in areas such as education, healthcare and pensions (where spending lags advanced economy rates). Lowering inequality is challenging, but improving the tax system – particularly to make it more progressive – is one part, as well as further reforms to the household registration (Hukou) system – to reduce the disadvantage of migrant workers.

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[1] Choukhmane, Taha, et al, *The One-Child Policy and Household Saving*

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