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Prospects for Consumption-Based Growth in China

by Christian Dreger and Yanqun Zhang

The Chinese model for economic growth is undergoing a fundamental reorientation. While output has been driven by investments and exports in recent decades, private consumption is expected to become a major trigger for future GDP growth. However, the conditions for higher demand from households are far from optimal: the savings rate is high, driven in particular by the low level of social security and highly regulated financial markets. It remains to be seen whether the government can transform China into a consumer society without causing major friction.

The People's Republic of China has just experienced a breathtaking phase of economic expansion. Real production has increased by an average of approximately ten percent per annum in recent decades. As a result, the country has contributed significantly to the growth of the global economy. China has since become the second largest economy in the world—it will probably take another few years before the US is dislodged from its position at the top of this ranking. However, economic growth in China is currently slowing: the increase in real gross domestic product (GDP) in the fourth quarter of 2012 was still at 7.9 percent, in the first quarter of 2013 the economy grew by 7.7 percent, and in the second quarter by only 7.5 percent. While this slowdown initially appears to be negligible, it could nevertheless be due to a development that might lead to permanently lower growth rates. The new Chinese government has signaled its intention to accept slightly lower GDP growth in future, possibly even over a longer period of time. The expansion of its economy might then fall below the threshold of 7.5 percent, regarded by many observers as a minimum to ensure adequate employment opportunities for its millions of migrant workers.¹ If jobs are no longer guaranteed, the political stability of the country might also ultimately be endangered—with substantial consequences for the global economy. Therefore, the report considers the causes of lower growth. How will the Chinese government deal with this process and what are the prospects of successfully transforming the Chinese economic model?

¹ The number of employees in rural areas has been declining for years. Job cuts due to the declining importance of agriculture to value added are particularly prevalent in state-owned enterprises. Redundant workers migrate to the cities to find work, particularly in the industrial sector. Despite the job cuts that have already been made in agriculture, more than a third of workers are still employed in this sector, while ten years previously the corresponding figure was approximately 50 percent.

Limitations of the Old Growth Model

China's economy was able to expand in recent years, mainly thanks to high levels of investment and increasing exports. The industrialized nations are crucial as sales markets for the export sector: approximately one-third of exports are delivered to the US and the member countries of the European Union (EU). Export dynamics have cooled significantly as a result of modest US growth and the debt crisis in the euro area. Exports to the US in the first half of 2013 rose by no more than two percent over the same period in the previous year; exports to the EU in the same period actually fell by five percent.

The Japanese government's economic stimulus measures have had a negative impact on Chinese export prospects: it has led to a depreciation of the Japanese yen and, in turn, to a revaluation of the Chinese renminbi. Consequently, the competitiveness of Chinese exporters deteriorated. Once again, it is clear that China is heavily dependent on development in the industrialized countries and cannot be regarded as an autonomous growth pole in the global economy.²

Foreign sales slumped sharply during the global financial crisis, by approximately ten percent in 2009. Although exports make up approximately one-third of GDP, a marked slowdown of growth was prevented because the government supported the economy by implementing various stimulus measures. According to the International Monetary Fund (IMF), the programs had a scope of around six percent of GDP spread over two years.³ This allowed production to increase at its usual pace. However, it has also delayed the transformation of the Chinese economy and increased the risks.

In particular, the economic stimulus package has kick-started investments in infrastructure. Furthermore, four public banks have given the country's enterprises generous loans to stimulate the economy. Credit checks have often not been as thorough as they might have been.⁴ State-owned enterprises in particular have benefited from informal lending practices, not only on

the basis of any common interests with the banks but also due to the supposedly lower default risk—from the banks' point of view—because the government would protect enterprises from bankruptcy in an emergency. However, the capacity of the government budget is not unlimited, and the risks could ultimately remain in the financial sector. Therefore, the proportion of potentially bad loans on bank balance sheets ought to have increased significantly.

In addition, local governments have apparently taken over management of the economic stimulus packages. While central government debt is officially only about 20 percent of GDP, the provinces are not included in that figure. No one currently knows precisely how high the real debt burden is. The government has commissioned the Court of Auditors to produce an overview of local government debt to create transparency.

The reactions of the government to the financial and economic crisis have exacerbated imbalances within the country. The investment to GDP ratio, which was already approximately one-third at the turn of the millennium, has increased to almost 50 percent due to the investment boom of recent years (see figure). As a consequence of government-prescribed low interest rates, credit has also been plowed into less productive sectors, leading to overcapacity. The transformation of the Chinese economy remains largely on track due to its one-sided promotion of outdated structures. Private companies still receive virtually no loans from the commercial banks and are dependent on a less transparent and probably also highly inefficient system of shadow banks. In many cases, they are forced to buy up foreign capital at excessively high interest rates.

The Chinese government may maintain its usual response pattern for a while longer and react with expansionary measures to counter the slowdown in growth. As long as growth remains sufficiently high, resources are generated that can be used to control the accompanying adverse effects. In addition, the country holds the most foreign exchange reserves in the world, and these can be used to stabilize the economy in an emergency. However, such a strategy would further increase the risks and development could veer out of control in just a few years. Therefore, the new government has apparently decided to shift toward a more sustainable economic course. It aims to achieve a more balanced growth path, with a greater focus on private consumption.

² See also C. Dreger and Y. Zhang, "China: Trotz hoher gesamtwirtschaftlicher Dynamik noch keine Lokomotive der Weltwirtschaft," Wochenbericht des DIW Berlin, no. 33 (2012).

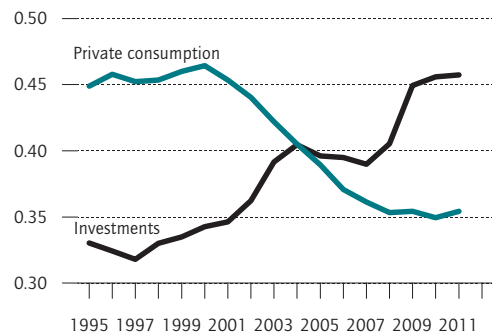
³ See also International Monetary Fund, "Navigating the fiscal challenges ahead," IMF Fiscal Monitor (Washington, D.C.: May 2010). The individual components of the stimulus package are, for example, discussed by B. Naughton, "Understanding the Chinese stimulus package," China Leadership Monitor 28 (2009).

⁴ The Bank of China, the People's Construction Bank of China, the Agriculture Bank of China, and the Industrial and Commercial Bank of China operate in different market segments. For an analysis of the structure of the Chinese banking sector, see F. Allen, J. Qian, C. Zhang, and M. Zhao, "China's

Financial System: Opportunities and Challenges," NBER Working Paper 17828 (2012).

Figure

Private Consumption and Investments in China Relative to GDP



Source: National Bureau of Statistics of China; calculations by DIW Berlin.

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Investments exceed private consumption by far.

Structural Factors Slowing Consumption

Households have continuously expanded their consumer spending in the past few years. Nevertheless, growth in consumption has been disproportionately low; its share of GDP fell in the course of the last decade from almost 50 percent to 35 percent at present. Around 80 percent of this consumption is accounted for by urban households, although the urban and rural populations are approximately the same size.

The relatively modest increase in private consumption is the result of various structural factors. For instance, previous gains in disposable income did not generally keep pace with GDP growth. For a long time, China's price competitiveness in export markets was paid for by low wage growth. Therefore, the disproportionately low increase in consumption can initially be explained by income development. Furthermore, an increasing proportion of disposable income is not being used for consumption at all, however, but is being set aside for a rainy day: the savings rate of households is almost 30 percent.⁵ One reason for this is the insufficient level of social security. Although the government has been spending significantly more on old age pensions and on sick and unemployment benefits since the turn of the millennium, this does not even amount to five percent of GDP overall. Spending is not expected to increase significantly in the near future, particularly not if government debt

proves critical. Many households are thus forced to provide for themselves to a large extent—a trend which is compounded by the statutory one-child policy and the decreasing average household size.

In addition, households are faced with liquidity constraints. Larger purchases are frequently financed by withdrawing savings since the corresponding loans are not available. For this reason, too, the development on the financial markets has little bearing on consumer behavior. Although low interest rates have encouraged investment, they have simultaneously slowed down growth of disposable income.

Reform Strategies Will Take Some Time

The country's new political leaders seem to have recognized the economic imbalances and are apparently prepared to take measures to put the economy back on a path of sustainable growth. Companies in sectors with overcapacities will not receive any new loans unless they want to use them to close down their operations. This indicates that the Chinese government is willing to accept a somewhat lower growth of GDP. The current five-year plan aims to base economic development on private consumption to a greater extent than previously. The crisis in the industrialized countries has massively contributed to the paradigm shift. The conditions for stronger consumer-based growth have not been fulfilled, however, so further reforms are still needed.

Greater consumption growth could initially be aided by a stronger increase in disposable income. On the one hand, higher wage growth could play a role here. In recent years, wages rose faster than productivity growth plus inflation, albeit from a low initial level. Furthermore, minimum wages have increased significantly, not least in order to prevent feared social unrest.⁶ However, high wage growth may make it more difficult to set up innovative companies. Employee earnings in the private sector are not directly regulated by the government—but state-owned enterprises offer higher wages and, in the competition for suitable staff, private companies are likely to follow suit. Therefore, wage growth which continuously exceeds the scope of a neutral impact on the income distribution would not be optimal and could have an adverse effect on employment. On the other hand, an increase in disposable income could also be supported by potentially higher interest rates as savings targets can be achieved with a relatively lower savings rate. At the same time, investment growth would

⁵ The aggregate savings rate of households, enterprises, and the government is over 50 percent of GDP.

⁶ See also C. Dreger and Y. Zhang, "Inflation in China ist zunehmend hausgemacht," Wochenbericht des DIW Berlin, no. 50 (2011).

slow down. As a result, production would be less capital intensive. Hence, a certain level of employment could be maintained even with lower output growth—particularly since the working-age population has already begun to decrease. Ultimately, the new strategy of ongoing urbanization should also promote consumption growth, since urban centers provide a better and wider range of consumer opportunities. However, this requires reforms in the household registration system, known as “hukou,” which classifies every Chinese citizen as belonging to the urban or rural population. The current regulation excludes, or at least makes it more difficult for migrant workers to receive many social security benefits.⁷

Liberalizing Financial Markets on the Agenda

One decisive factor in the change of direction of the Chinese growth model is the further liberalization of the financial markets. Private companies and households need easier access to loans so that liquidity restrictions become less binding. Particularly in the banking sector, reforms should be made to encourage competition. Initial steps in this direction have already been taken: for instance, the central bank recently allowed lending rates to be reduced, meaning that banks can offer households and companies lower interest rates. Before restrictions were relaxed, this was only possible within a band fixed by the central bank. It is not clear, however, to what extent this reform does in fact stimulate private demand. Private stakeholders do not receive any loans from the state-owned banks in any case. Consequently, this step could primarily serve to reduce the borrowing costs of public debtors and ailing state-owned enterprises and to save heavily indebted local governments. Furthermore, the banks retain an increasing proportion of potentially bad loans on their balance sheets, so they have become more cautious about lending. The demand for loans is therefore likely to remain high for financial institutions that do not cut their interest rates.

Maximum and minimum limits still apply to interest on cash deposits. The abolition of the fixed bands should have a major impact, at least on households. The banks would then have to compete for savings with higher interest rates. Greater market liberalization, also for foreign banks, could help squeeze out the largely unregulated and opaque shadow banking sector. Economic growth would be determined to a larger extent by the domestic economy.

Policy Implications

More heavily consumer-based growth in China requires structural reforms: besides urbanization, these include easier access to urban social benefits for former rural populations and a liberalization of the financial markets so that liquidity restrictions are less binding. Rising interest rates could also contribute to higher consumer growth if they lead to lower savings rates. A sustainable expansion of the currently relatively low level of social security should stimulate spending by households but is not likely to be implemented in the near future due to heavily indebted public budgets.

Although the one-child policy eases the situation on the labor market on the one hand, it could lead to another increase in savings rates on the other hand: since this policy has led to a surplus of men in the population, households are also saving to improve the chances of their male line of descendants on the marriage market.⁸

Overall, the transition to more consumer-based growth in China is not likely to be a smooth one and is expected to take quite some time.

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⁷ See C. Dreger and Y. Zhang, “Understanding Chinese consumption. The impact of Hukou,” DIW Discussion Paper 1341 (2013).

⁸ See S.-J. Wei and X. Zhang, “The competitive saving motive: Evidence from rising sex ratios and savings rates in China,” *Journal of Political Economy* 119 (2011): 511–564.

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