Investment Insights

Will China succeed in boosting consumption?

June 2010

Structural change to China's growth model

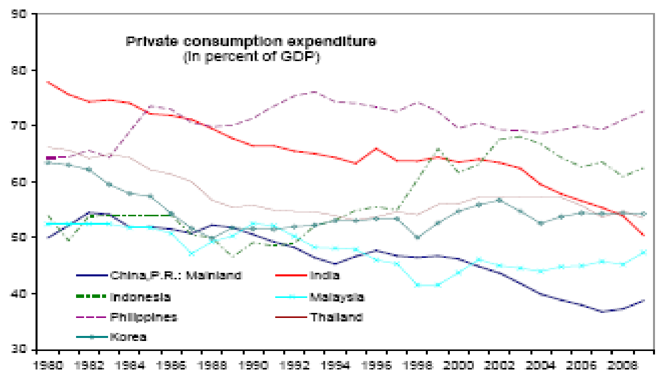
Although fears of hard landing or policy risks in China and the debt crisis in Europe have dominated news headlines recently which could remain an overhang on global markets including Chinese equities in the short-term, investors should not forget that the Chinese authorities still have strong intentions to boost domestic consumption.

China's GDP growth has long been mainly driven by investment and exports. The latest global credit crisis with the subsequent collapse of the export sector has provided Beijing with the renewed urgency to accelerate various consumption initiatives, including new measures in the healthcare, education, pension, housing and social services.

Falling consumption over past 30 years

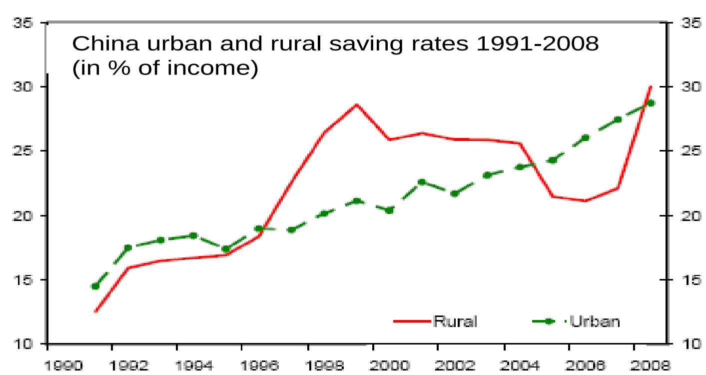
- With an average economic growth of 10% over the three past decades, it is difficult to imagine that household consumption as a share of total economic output has been declining in the past 30 years. Household consumption fell from 55% of GDP in early 1980s to 37% in late 2000s, much lower than the 50% average among both developed and emerging countries.
- The decline in the consumption ratio can be partly explained by higher precautionary saving due to the still-insufficient basic social safety net. The Mainland's urban household savings rate amongst different income groups has been rising, while the rural savings rate increased quickly in 1990s but then started to fall since early 2000s, though the current level is still much higher than during the 1990's.
- The savings rate jumped even more sharply between 1996 and 1998 when there were aggressive reforms in the state-owned enterprises (SOEs), as the social welfare of workers and their families were previously the responsibility of the SOEs.
- Hence, the dismantling of many inefficient SOEs and the move from public to private sector employment resulted in the collapse of the social safety net in 1990s, leaving a massive gap in social provision. Government healthcare spending, for example, fell from 51% of total expenditure on healthcare in 1995 to a low of 36% in 2001, while 2006's 42% is still amongst the lowest in the world.

China's consumption is one of the lowest in Asia



Source: IMF Working Paper WP/10/69, Mar 2010.

Increasing saving rates in both rural and urban areas



Source: IMF Working Paper WP/10/16, Jan 2010.

- China spends about 6% of GDP on government provided healthcare, education and social security, whilst the OECD spends on average 28%. This is key in any explanation of the significant differences in savings rates. OECD populations "save" through taxation in exchange for the governments' provided services.

- In contrast, Chinese residents save themselves in order to meet these potential liabilities. This is likely to be economically inefficient, since it is easy to imagine that Chinese people overinsure to make sure that they can meet a spike in liabilities, especially unpredictable healthcare costs.

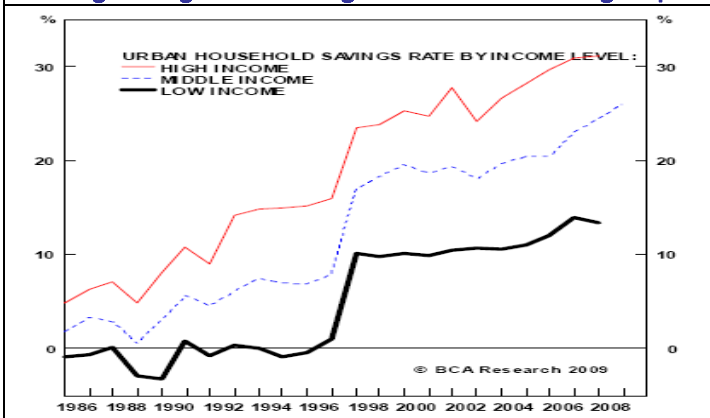
- Furthermore, savings rates have increased across all demographic groups in the Mainland. Interestingly, younger and older households which have higher average income than the middle age workers also have relatively higher savings rates in recent years, different from the pattern in early 1990s when both average income and saving rate initially increased with age, peaked at around age 50 and then declined. *(Source: Brookings Global Working Paper 31, Dec 2008; Finance & Development Vol. 46, No. 4, Dec 2009)*

- With the population aging and income levels rising, it is understandable that the demand for healthcare is increasing. With rising income trends having bypassed many of the elder generation, the elderly have no choice but to save more.

- Also, in an economy with rapid growth and household incomes growing an average 13% over the past decade, the desired consumption bundle is shifting toward big-ticket durable goods such as electrical appliances, autos and apartments.

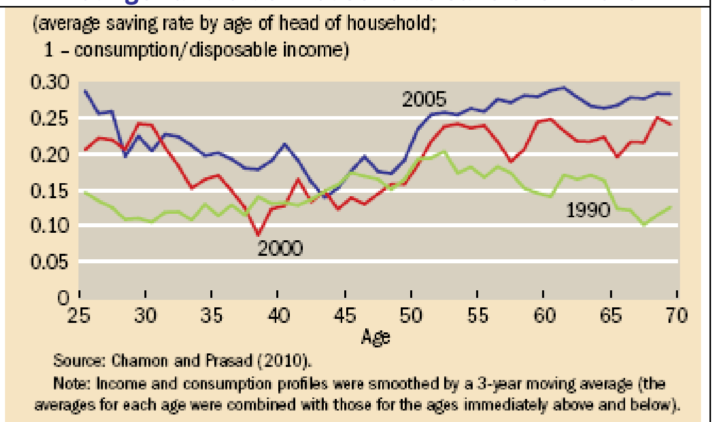
- Combined with the lack of alternative investment options or diversification opportunities apart from bank deposits (which barely keep up with inflation), equities (highly volatile) and physical property (more severe credit measures for second homes), this could cause younger households to save more for precautionary purposes.

Rising saving rates amongst different income groups



Source: BCA Research, Sep 2009.

Younger and older households save even more



Source: Finance & Development Vol. 46, No. 4, Dec 2009.

Will the government succeed?

Increasing social welfare spending

- Given the official theme of "building a harmonious society" outlined in 2005, social welfare expenditure has been rising quite significantly in recent years. The Chinese authorities announced early last year a RMB 850 billion (USD 120 billion) plan to cover 90% of the population with some basic healthcare programmes, rising from around 50% in 2009.

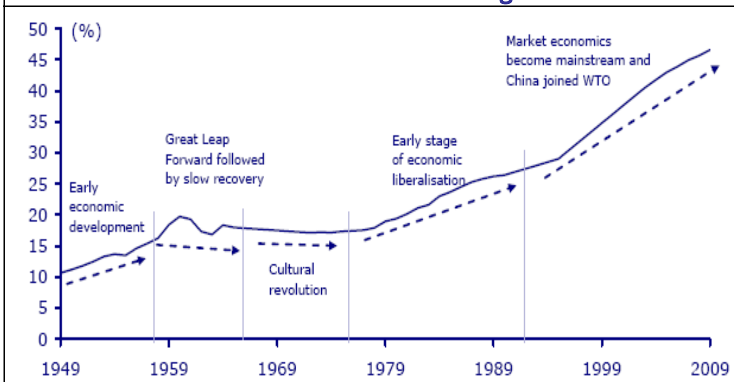
- The recent announced strong commitment in the government's welfare/affordable housing programmes for 2010 came in much at 7 million units with 5.8 million and 1.2 million in urban and rural areas, respectively, much higher than the expected 3 million units. If the implementation goes well, this should ease concerns about the social stability issues and boost private consumption in the medium- to long-term.

- A recent IMF working paper (by E Baldacci, G Callegari, D Coady, D Ding, M Kumar, P Tommasino & J Woo, Mar 2010) shows that a 1% of GDP increase in social spending (around 6% of GDP for China currently) can reduce household savings by 0.56-1.03% of GDP, with the impact of healthcare the most significant (by 2.09-2.12%), education coming second (by 1.26%) and social security having the least impact (by 0.68-0.72%).
- More importantly, the study also highlights that a sustained 1% of GDP increase in public spending, allocated evenly across education, health and pension, would result in a permanent increase in household consumption of up to 1.25% of GDP.
- Another study (by S Barnett & R Brooks, January 2010) also has similar findings. The government spending on healthcare has the largest impact on reducing urban household saving. A RMB 1 increase in government healthcare spending can increase household consumption by RMB 2.

Accelerating urbanisation

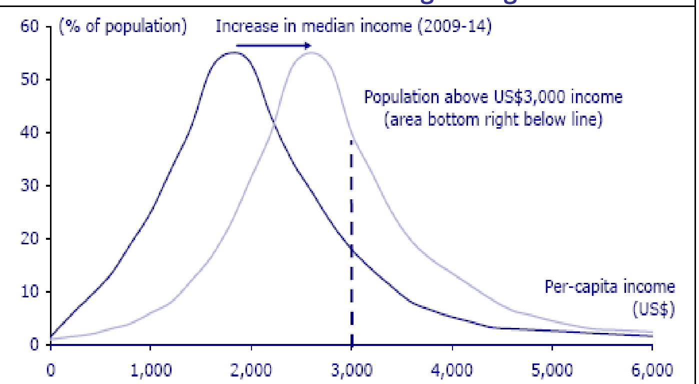
- To speed up urbanisation the Chinese authorities have to accelerate the "Hukou" (residency status) reform, which has been regarded as the last remaining fort over the past 30 years of reform. The "Hukou" system is an instrument of the command economy to control migration from rural to urban areas to ensure stability.
- China has an impressive urbanisation rate of 47%. However, if migrant workers are excluded, the urbanisation rate drops to only 29%. Migrant workers account for 27% of the working population. As they still face uncertain residency status, they tend to save much more than the urban citizens with "Hukou".
- This "Hukou" system not only makes migrant workers hesitate to spend, it also inhibits labour mobility and hence, dampening productivity growth as many of the rural workers are not able to move to the urban cities with shortage of labour.
- Starting from this year migrants are allowed to settle in small and medium-sized cities with population less than 500,000 and receive full entitlement to social services. Further reform of the "Hukou" system will help boost domestic consumption in the longer term.
- A McKinsey study expects 350 million people will be added to the urban population by 2025 (more than the present US population). The total of nearly one billion people living in China's urban cities will then account for over 90% of the country's GDP.

Urbanisation has been accelerating since 1990s



Source: CEIC, McKinsey analysis, CLSA, 17 May 2010.

China's median income shift and growing middle class



Source: CLSA, 19 Apr 2010.

Growing middle class population

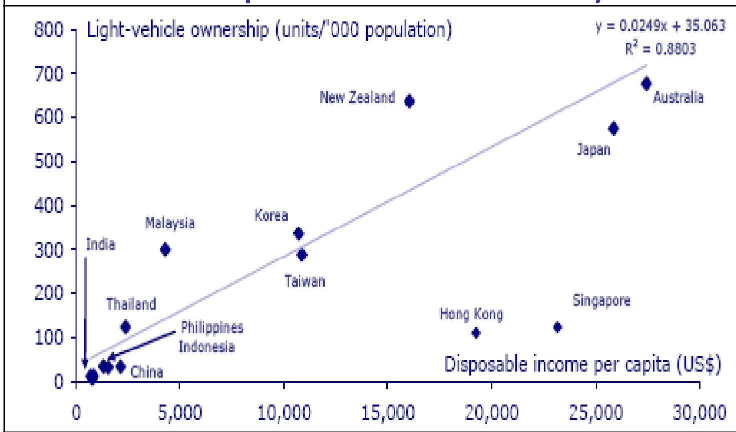
- A CLSA report "Mr & Mrs Asia - Moving up the J-curves" expects China to enter a "hypergrowth" phase over the next 5 to 10 years given rising incomes and a propensity to consume as well as the willingness to take risks. According to their forecasts, the amount of middle class in Asia ex-Japan with per-capita disposable income of more than USD 3,000 will rise to 945 million from 570 million over the next 5 years, with China and India accounting for 85% of the increment.

- The report also estimates that the consumption spending of this middle class will rise from USD 2.9 trillion to USD 5.1 trillion by 2015, with China contributing 69% of the increase. Median income for China is projected to increase from USD 1,900 in 2009 to USD 2,700 by 2014 with 44% of the population's earnings exceeding USD 3,000, up from 27% in 2009.

- There is already good evidence of the robust demand from China's middle class and its exponential growth potential. For instance, China became the world's largest auto market with sales of 10.3 million units in 2009. However, its total vehicle population is just 62 million and penetration level is merely 5%, significantly lower than 80% in the US.

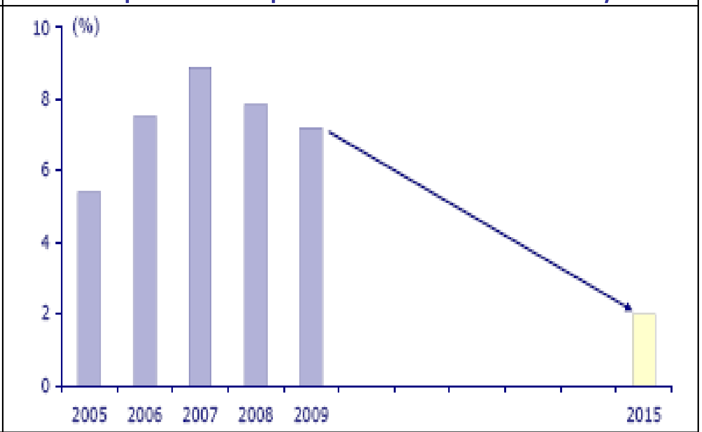
- China is also the largest telecom market in the world today, generating over RMB 870 billion of revenue and RMB 370 billion capex in 2009. The number of mobile subscribers grew to 747 million in 2009 with a penetration rate of 56%, up from 24 million in 1998. Broadband, with the penetration rate of 7.7% in 2009 compared to 22% OECD average, will be the next growth driver.

China's auto penetration is still extremely low



Source: *Ashwin Chotai, Euromonitor, CLSA, 19 Apr 2010.*

NDRC expects net exports to fall to 2% of GDP by 2015



Source: CEIC, CLSA, 17 May 2010.

Conclusion

Investment drove a record 90% of GDP growth in 2009, which is unsustainable in the long term. Also, the National Development and Reform Commission (NDRC) forecasts that net exports will account for only 2% of GDP by 2015, down from 8% in 2008. Hence, to keep economic growth sustainable at around 8%, the Chinese authorities have to accelerate economic restructuring to increase the country's self-sufficiency.

Empirical research shows that an increase in social security spending would bring down savings rates and help shift China's growth from investment and exports towards consumption. Accelerating urbanisation as well as the growing middle class population given the rising incomes will also raise the demand for domestic consumption of goods and services. This is the real rebalancing required by China to transform the country structurally to a domestically-driven economic growth model.