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Anthony Chan

Asian Sovereign Strategist
Global Economic Research

+ 852 2918 7846

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China's Next Leap Forward: Will It Be as World's Biggest Consumer?

The transformation of China into the world's manufacturing centre resulted in the highest investment-to-GDP ratio among major economies. This has made the country a dream market for producers of commodities and machinery. Following the retrenchment of world trade and Beijing's greater emphasis on domestic demand as a growth strategy, a hotly debated theme has emerged: will China's next leap forward transform the world's factory into the world's consumer?

Short-Term Boost

In terms of cyclical trends, China's consumption growth should stay strong in the coming year as the effects of recent countercyclical measures to boost household spending work through the economy. The measures target mainly the rural household sector, providing income subsidies and tax concessions to mobilize bank savings totaling trillions of renminbi into a spending spree. Rural households are bombarded with such messages as "Bring home appliances to the countryside" and "Bring automobiles to the countryside" which—while reminiscent of state planning slogans of the 1950s and 1960s—have actually boosted consumer spending. Recovery in the property sector has also helped keep consumerism alive and well, as indicated by high sales volumes for household appliances, furniture and home decoration materials.

Long-Term Solution

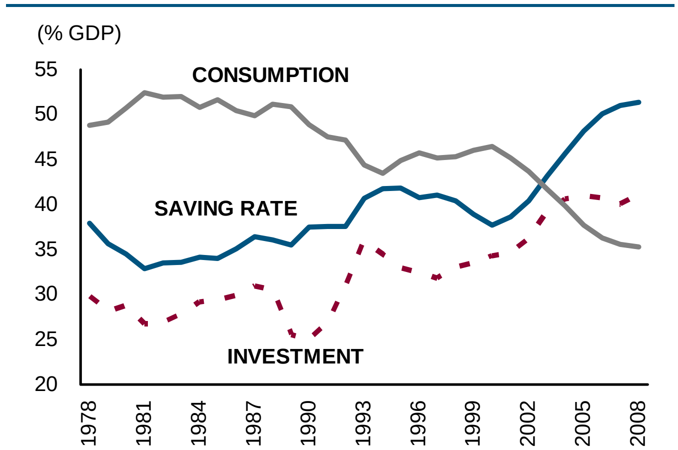
The effects of the countercyclical stimulus will eventually fade, however, and China needs to do more to turn its currently robust consumption growth into a secular growth trend. In keeping with its long-held goal of relying less on investment and more on consumer spending to drive GDP expansion, the country has announced significant steps to lower its very high national saving rate (51% of GDP). One is an aggressive campaign to expand and deepen social security and embark on healthcare reforms for its 800 million workers as a way of reducing the household sector's precautionary saving (saving against a "rainy day")—a major cause of the high saving rate. Another initiative is to turn the rural population into a new source of consumer demand. Rural households have badly lagged their urban counterparts in terms of income and wealth throughout China's decade-long economic boom. To rectify this, Beijing needs to implement to good effect the rural reform policy it announced late last year at the Party Congress. Measures such as the privatization of farmland and secondary sale and purchase of rural land will create a once-only transfer of wealth to rural people, who will divert some of their newfound wealth into consumption.

Structural Constraint

Display 1 clearly shows that China has done an excellent job of boosting savings to support a highly investment-driven growth model.

Display 1: High Saving and Investment, Low Consumption

China's Structural Trends



Source: CEIC Data and AllianceBernstein estimates

Perhaps it has done too well. The mirror image of over-saving in the household sector has been a falling consumption-to-GDP ratio, as household saving has far exceeded saving in the corporate sector. Indeed, the jump in the saving rate since the turn of the century is a direct consequence of the state enterprise reforms and downsizing of the 1990s. The schools, medical facilities and social welfare which used to be part of the “iron rice bowl” package for state workers were abruptly phased out and replaced by a more market-based pricing mechanism. The result was an increase in precautionary saving at the expense of new spending.

The RMB4 trillion fiscal package directed at infrastructure investment grabbed world headlines when announced early this year. Far less attention has been paid to a RMB1.4 trillion spending program, of which RMB850 billion (US$125 billion) and RMB300 billion (US$44 billion) has been earmarked for healthcare and social security reforms respectively. These initiatives include a broad range of very specific measures and targets for improvements in medical care and the national pension scheme’s penetration into the population.

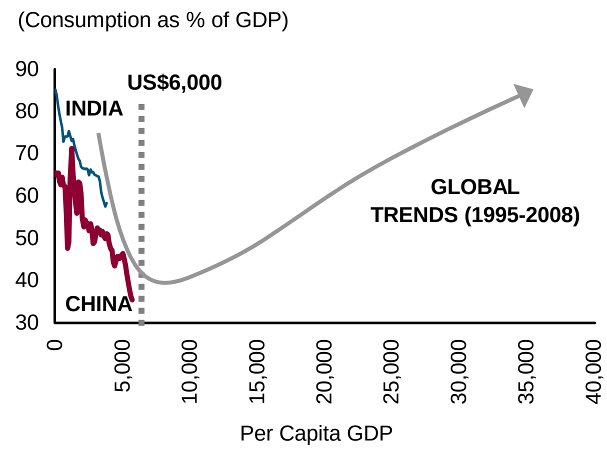
China spends about 2% of GDP annually on healthcare, which is considerably less than the US’s 15% and the 6%–8% spent by Japan, Korea and Britain. It has much to do to bridge the gap and has a grand plan, which is to create an equitable and universal health care system by 2020. It also aims to have 90% of the population covered by some sort of basic medical insurance by 2011 and to increase significantly the amount it spends on building hospitals and clinics in urban and rural areas.

The objective of the pension scheme reforms is to redistribute income from the corporate sector to households by enforcing stricter requirements on employers’ contributions. Perhaps the most important policy proposal in this area is to make the pension accounts of migrant workers transferable across provinces. This will greatly boost pension coverage (the government aims to add 200 million migrant workers to the scheme) and reduce individuals’ precautionary savings. Only 17% of migrant workers have joined the nontransferable local pension scheme.

Time Is Right for Structural Transformation

It is too soon to predict whether China can achieve its social welfare reform ambitions and ramp up consumption as powerfully as it lifted investment and manufacturing exports over the past decade. That said, a recent study by Nomura Research suggests the time is right for China to transform itself into a consumption-driven economy. The study argues that major economies tend to have a falling consumption-to-GDP ratio and a correspondingly rising investment ratio when income levels are low. Once per-capita income rises to around US$6,000 in purchasing-power parity (PPP) terms, structural changes take effect: the consumption ratio bottoms and starts to climb while the reverse occurs to the national investment rate (**Display 2**).

Display 2: An Inflection Point Is at Hand
Per-Capita GDP vs. Consumption as Percent of GDP

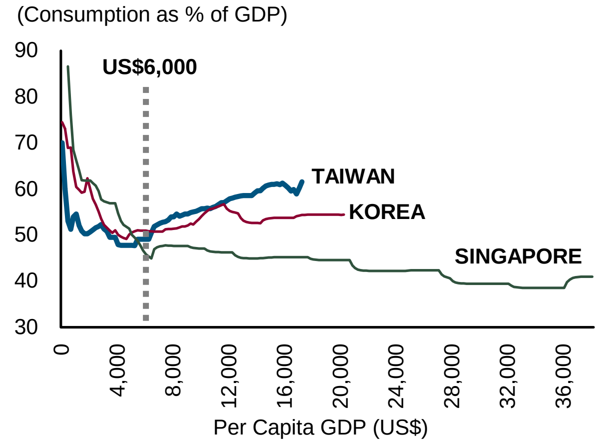


Source: Nomura and AllianceBernstein estimates

The simple explanation for this is that rising income and saving promote confidence in the future. Factor in a competitive banking system and adequate, government-supplied healthcare and social welfare, and the scene is set for consumption to take off. China’s per-capita GDP (in PPP terms) is approaching the threshold level. Borrowing Nomura’s methodology, we have tested the experience elsewhere in Asia: the result is positive for Taiwan, less so for Korea and not at all for Singapore (**Display 3**, next page).

Display 3: The Asian Experience

Per-Capita GDP vs. Consumption as Percent of GDP



Source: CEIC Data and AllianceBernstein estimates

In Korea, consumption took off when per-capita income reached US$10,000–US$12,000. The spree was short-lived, however. It coincided with the corporate debt crisis linked to the Asian financial crisis of 1997–1999, as a result of which local banks became keen to restructure their balance sheets away from large conglomerates (the Chaebols) in favor of developing a consumer finance market. The subsequent credit card crisis and consumer loan defaults restricted growth in consumption and the services sector. As for Singapore, we believe the continued decline in its consumption ratio—despite per-capita income of US$38,000—reflects the high national pension contribution.

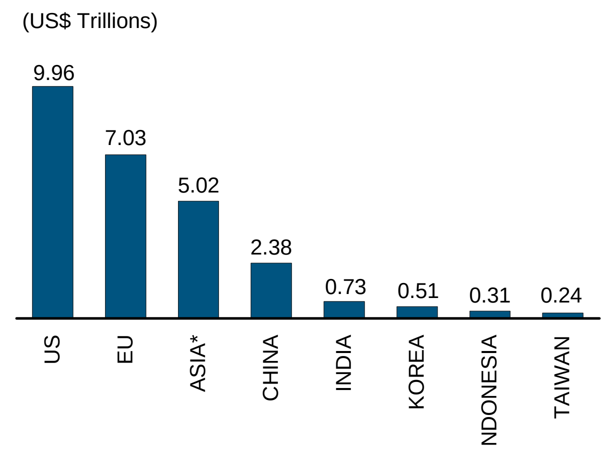
We expect China's development to resemble that of Taiwan, with a steady rise in the consumption ratio as income grows. The lesson to Chinese policymakers from these comparisons is to avoid repeating Korea's mistake—a pertinent comment in view of Beijing's recent decision to permit the establishment of consumer finance firms, thereby paving the way for an expansion in consumer finance (car loans and credit cards, etc.). If the above observations comprise the recipe for a successful consumption-growth policy, the one ingredient still missing in China's case is sufficient social welfare and security protection to allow incomes and savings to translate into higher spending. Beijing is at least addressing these issues on an unprecedented scale. As long as the country's growth performance stays strong, we think the outlook for consumption will be positive.

Long-Term Outlook and Implications

China's emergence as a major consumer will be important for the rebalancing of the global economy, but it will be some time yet before Chinese consumers overtake their US counterparts. We estimate that private consumption expenditure this year will total around US$10 trillion in the US and about US$7 trillion in the EU. China's consumer spending is around US$2.4 trillion. Within Asia, China accounts for half of the region's spending and leads the second-biggest spender—India, which makes up 15% of the total—by a large margin (**Display 4**).

Display 4: China's Spending Is Only a Quarter of US

Private Consumption Expenditure (2009 Forecasts)

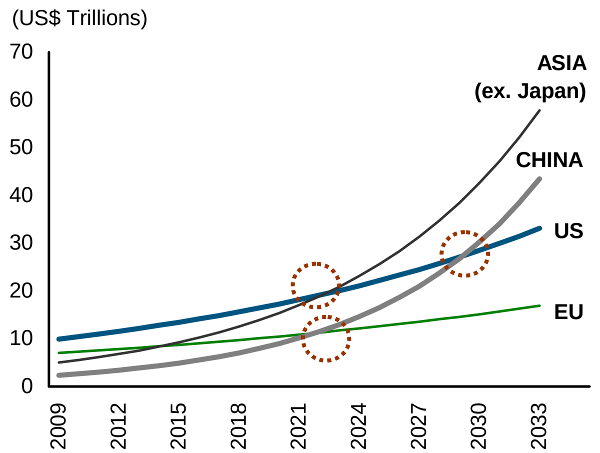


*Ex Japan
Source: CEIC Data and AllianceBernstein forecasts

If we do a simple straight-line projection based on the assumptions that 1) the average nominal growth (in US$ terms) of each country's consumer expenditure since the turn of the century will remain constant in the future, and 2) each Asian currency will appreciate against USD by a modest 1% a year, the outcome is not too surprising. We estimate that by the time non-Japan Asia's consumer spending overtakes that of the US in about 15 years, China's consumer spending should exceed the EU's. It will probably take another five to 10 years for China to overtake the US (**Display 5**, next page).

Display 5: Rise of the Asian Consumer

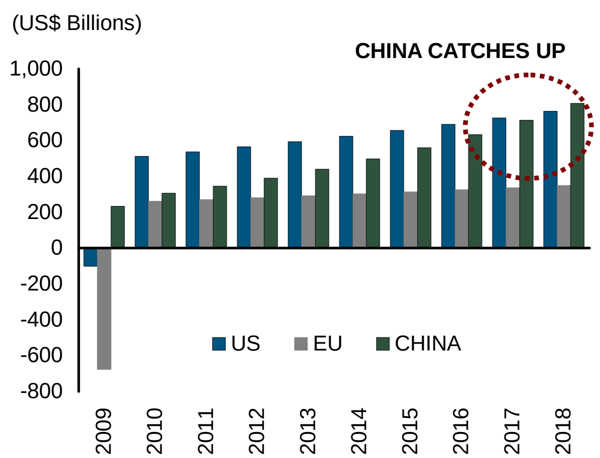
Forecasts of Private Consumption Expenditure



Source: CEIC Data and AllianceBernstein forecasts

Display 6: China Will Be Fastest-Growing Consumer Market

Forecasts of Incremental Private Consumption Expenditure vs. Previous Year



Source: CEIC Data and AllianceBernstein forecasts

We believe, however, that the important investment implication is not the absolute size of the consumer market, but the incremental change in consumption. We estimate that Chinese consumers will spend US$240 billion more this year than last year, which will more than offset this year's likely shrinkage in US consumer spending. Within the next 10 years, China will be the fastest-growing consumer market in the world—crucial to global growth and a dominant factor in any company's business strategy (**Display 6**).

This forecast is not without qualification, however. Currently, about half of China's imports are commodities and raw materials and only 20% are consumer products. China itself is the world's largest producer of consumer goods. Increased domestic consumption, therefore, may benefit homegrown as much as foreign brands. In other words, China's emergence as a consumer may not be as significant for the world's consumer goods manufacturers as its growth in investments and exports has been for global commodity and machinery suppliers.

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