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Consumption to be Mainland China's Next Growth Driver

- The Mainland authorities have long tried to promote private consumption as a major driver of growth along with investment and exports, as this might help reduce economic volatility and uncertainty. Measures were taken as early as in 1999 to boost private consumption, but progress has been slow.
- Possible rise of precautionary saving since economic reform, when many of the formerly free services by state-owned enterprises such as housing and medical care have to be bought by households now, is one reason that caps consumption. The much lower income of rural residents, which accounts for over half of the Mainland's population, than urban residents, and the relatively underdeveloped consumer credit market on the Mainland, also restrict the growth of consumption.
- A key to promoting private consumption lies in improving the social safety net. Accelerating the development of the rural areas especially the inner region, and expanding the consumer credit market would also help. The Mainland authorities have been moving in these directions for some years, but more can be done to accelerate the process, including measures to speed up the development of the service industry.
- Most of the measures, however, are geared to long-term development needs and improving living standards and, hence, are unlikely to have any noticeable impact on consumption in the short term.

Ever since mainland China started its economic reform in 1979, the country's economic growth has been driven mainly by investment and exports. This was especially obvious since the mid-1990s when the Mainland accelerated domestic investment and opening. Between 2000 and 2007, the Mainland's economy grew by an average of 14.3% a year in nominal terms, of which 56.6% was contributed by investment and net exports. Private consumption contributed only 30.1%. The remaining 13.3% of the growth was generated by government spending.





One problem with this growth pattern is that economic growth could be more volatile. Between 2000 and 2007, the average contribution of private consumption to the Mainland's economic growth was 4.3 percentage points per year, with a standard deviation of 0.9 percentage point ⁽¹⁾. This means that about 68% of the data points (assuming a normal distribution) falls within 0.9 percentage point of the average contribution. This compared with the much bigger standard deviations of 2.4 percentage points for investment and 1.7 percentage points for net exports in the same period.

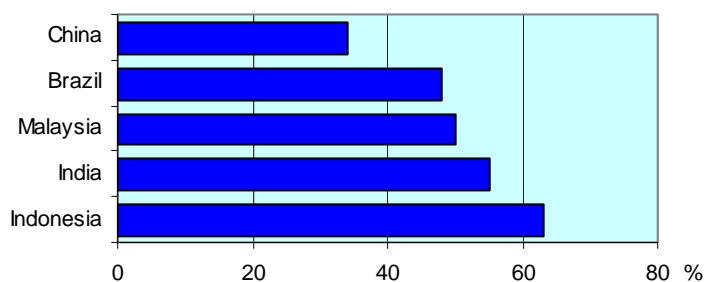
Another problem is that investment and export-led growth often requires ever increasing input of energy, raw materials and resources, which are environmentally costly. The Mainland's experience also shows that investment-led growth could lead to wasteful investment, rising bad loans and economic overheating, while export-led growth runs the risk of trade friction and exposure of the country to external shocks.

The Mainland authorities are well aware of these problems. For years, they have tried to change the growth structure by promoting private consumption as one of the major growth drivers along with investment and exports. As early as in 1995 when the authorities held their 14th Party Congress, shifting the driver of economic growth to one that relies more on the quality rather than quantity of inputs was formally written into the Party's policy directive ⁽²⁾. This was later translated into concrete policy objectives in the government's 11th Five Year Plan (covering the period of 2006-2010). Various measures have since been implemented for this purpose, but progress has been slow.

Private consumption share of GDP falling

Between 2000 and 2007, private consumption as a share of GDP dropped steadily in mainland China from 46.4% to 35.4%, making it the lowest among the major developing countries (Exhibit 1).

Exhibit 1: Household consumption as share of GDP



Source: World Development Report, 2009, World Bank

¹ Standard deviation is a statistical measure of the variability or dispersion of a data set. A bigger standard deviation indicates that the data points are more "spread out" from the average value (the mean) than a smaller standard deviation does. By the same token, a smaller standard deviation means that the data points are "closer" to the average value.

² From "CCPCC's proposal regarding the formulation of the 9th Five-year-plan and the 2010 long-term targets 《中共中央關於制定國民經濟和社會發展“九五”計劃和2010年遠景目標的建議》”。 The change was one of two fundamental changes to be made to the economy. The other one was the transformation of the centrally planned economy to a socialist market economy.





A possible reason is the rise of precautionary saving by households. Years of economic reform has relieved the government of many of the services formerly provided free to households via state enterprises, such as housing and medical care. Free compulsory education up to middle school has been provided nationwide only since late 2008. Spending on housing, health care and education now accounts for about 30% of the total urban household spending, having risen from 20% back in 1995 (Exhibit 2).

Exhibit 2: Urban household spending by categories (% of total)

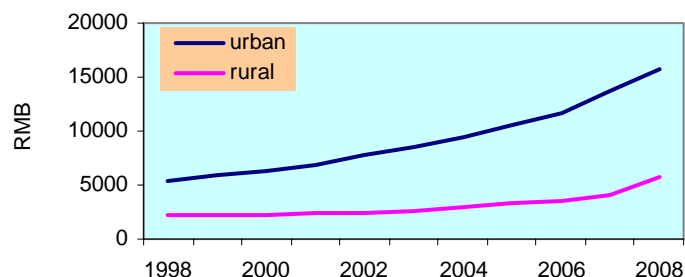
	1990	1995	2000	2005	2007
Food	54.3	50.1	39.4	36.7	36.3
Clothing	13.4	13.6	10.0	10.1	10.4
Housing, health care & education	20.1	20.5	31.1	31.6	30.1
Transport & communication	1.2	5.2	8.5	12.6	13.6
Other	11.0	10.6	11.0	9.0	9.6
Total	100.0	100.0	100.0	100.0	100.0

Source: China Statistical Yearbook, 2008

While it would be difficult to quantify the impact of rising financial pressure on consumption, per capita saving as a share of per capita income in urban areas did rise from 22% in 2002 to 30% in 2008, pointing to the possibility that some of the increase in saving was due to precautionary motive.

Another reason is that rural residents, which account for 55% of the Mainland's population, want to increase spending but could not afford to do so. In 2008, per capita income in rural areas was only 33% that of urban areas (Exhibit 3). Not surprisingly, per capita saving as a share of per capita income in rural areas was only 8% in 2008, implying that there might not be much left for other consumption after spending on necessities. If there is rising pressure for urban households to increase precautionary savings, it would be even more so for the much poorer rural households.

Exhibit 3: Annual per capita income in mainland China



Source: China Statistical Yearbook, 2008





Apparently, the lack of a developed consumer credit market on the Mainland also deters the growth of private consumption. Consumer credit on the Mainland only started to take off in 1999 when, amidst sluggish domestic demand, the authorities encouraged banks to expand consumer credit as a means to boosting private consumption. Since then, consumer credit as a share of total loans outstanding rose steadily from 0.5% in 1998 to 12% by end-2008. But even this level is low compared with about 30 to 50% in other major economies (Exhibit 4).

Exhibit 4: Consumer credit in major countries/ territories

	As share of total loans outstanding (%)	As share of GDP (%)
Mainland China /1	12.3	12.4
Thailand (estimated) /2	26.0	21.6
Hong Kong SAR /3	34.3	51.5
Malaysia /4	49.3	48.3

Sources:

1. Consumption loans; People's Bank of China
2. Personal consumption loans from commercial banks plus housing loans from Government Housing Bank. "All commercial banks' credits classified by types of credit", Bank of Thailand; Government Housing Bank Annual Report, 2007.
3. Loans of authorized institutions to private and professional individuals, except those for business purposes; Hong Kong Monetary Authority.
4. "Loans by purpose and sectors: banking system"; Monthly Statistical Bulletin, January 2009, Bank Negara Malaysia (Malaysian central bank).

However, with over 80% the Mainland's consumer credit outstanding comprising mortgage loans (³), the underdevelopment of the Mainland's consumer credit market might be partly the result of the authorities' cautious approach in developing the overheating-prone property market. Had the Mainland's property market been more developed, consumer credit outstanding would have been much higher.

What has been done to boost private consumption?

A key to promoting private consumption, according to the above discussion, is to reduce people's precautionary motive to save via raising their disposable income, that is income net of taxes and national insurance contribution. One way to achieve this is to perfect the existing social safety net, another is to accelerate the development of the rural areas, especially the inner region. The Mainland authorities have been moving in these directions for some years, but much more needs to be done.

³ Mortgage loans also constitute the majority of total loans outstanding in other major economies including Hong Kong SAR (75.2%), Malaysia (53.7%) and Thailand (60.3%).





On perfecting the social safety net

Mainland China started to establish a social security system in the 1990s. But in the course of implementation, various problems emerged including inadequate funding and limited coverage. Today, the Mainland still only has the most basic social security that covers mainly urban residents. A draft of the country's first social insurance law was only released recently in which the common right of urban and rural citizens to social insurance for medical care, unemployment, work injuries and childbirth was specified.

Currently, the government is working on a comprehensive health system reform plan that would provide universal coverage of basic health services. The plan, the outlines of which were announced in October 2008 (Exhibit 5), will scale up basic health protection, improve medical service delivery, and provide more equal basic public health service among regions and between cities and the countryside. Farmers, low income urban families and senior citizens will benefit most under the plan. The first government funding for the reform plan will amount to RMB850 billion for the period 2009-2011 (about RMB283 billion a year or 0.9% of 2008 GDP).

Exhibit 5: Outline of mainland China's health system reform plan

Ingredients		Targeted groups	Government subsidy
A public health system		All	Details not available
A basic medical service delivery system		All	Details not available
An essential drug supply system		All	Details not available
A health protection system	an urban resident basic medical insurance	Urban residents, with focus on the elderly and children	RMB80 per person now; increase to RMB120 by 2010
	An urban employee basic medical insurance system	employees and retirees from financially stricken state enterprises; other employees	RMB30-50 billion a year
	a new rural cooperative medical system	Rural residents	RMB80 per person now; increase to RMB120 by 2010
	a medical assistance programme	to subsidise health care premium and costs for the very poor	may increase to RMB6 billion per year

Source: “關於深化醫藥衛生體制改革的意見(徵求意見稿)”, Xinhua News, 14 October 2008; China Quarterly Update, March 2009: World Bank



On raising rural income

Compared to the establishment of the social safety net, works to alleviate rural poverty have gained greater momentum in recent years. Numerous projects with government funding support have been launched to improve rural infrastructure and reduce the financial burden of rural households. In 2000, a massive programme that aims at lifting the income of the western region was initiated⁽⁴⁾. Special incentives were provided to attract domestic and foreign investment to the region.

Since 2003, a government-sponsored medical care scheme known as the New Rural Cooperative Medical System was launched in selected counties under which each rural resident will receive 65% coverage of their medical expenses⁽⁵⁾. Beginning 2006, students in the western region and part of the central region have received free education up to middle school, a policy that has been extended nationwide since late 2008

To reduce the financial burden of rural families, all agricultural taxes have been eliminated since 2006. The rural land reform announced in October 2008 represents the authorities' yet another move to raise rural income. The new policy will provide greater protection to farmers' land use right and land transfer. In the long run, it should promote larger-scale farming operation (as opposed to the presently household-based one) and encourage rural-urban migration, which should improve farming efficiency and increase rural income.

What more could be done?

Impressive as the above measures look, more can be done to accelerate the process. Eliminating the under-pricing of industrial inputs such as those of land, energy, water, utilities and natural resources via price increases, tax measures, pollution charges and price reform, for example, would help shift society's emphasis from industry to services. At present, the Mainland's services industries account for only 40% of GDP, much smaller than the 60 to 80% in some major economies⁽⁶⁾. A more developed services sector would be conducive to the growth of private consumption.

Expanding the consumer credit market would have similar effect. Presently, over 80% of the Mainland's consumer credit is composed of mortgage loans compared with about 50 to 75% in other major economies. This means that there is room for expansion in other kinds of consumer credit such as loans for purchasing cars or other consumer durable goods.

⁴ The region covers 12 provinces and municipalities, they are Shaanxi, Gansu, Ningxia, Inner Mongolia, Qinghai, Xinjiang, Sichuan, Guizhou, Chongqing, Yunnan, Guangxi and Tibet. In 2008, the region accounted for 27.5% of the Mainland's population and 19.3% of total GDP.

⁵ Known as the New Rural Cooperative Medical System, the scheme was launched in selected counties in 2003 under which each rural resident can participate by contributing RMB10 a year, matched by RMB20 contributions from each of the local and central governments.

⁶ For example, South Korea (57%), Japan (70%) and USA (76%). OECD



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Overall, there are still lots that the authorities can do to promote private consumption. Ironically, the recent global downturn has accelerated the authorities' move in this direction. Huge amount of funds have since been assigned for improving infrastructure in the rural areas and subsidising rural families' purchases of certain household appliances, and providing subsidised housing to poor urban families (Exhibit 6).

Exhibit 6: Measures for stimulating private consumption since 4Q 2008

Sector	Details
Rural economy	<ul style="list-style-type: none"> - RMB370 billion out of the RMB4 trillion stimulus plan to be spent in 2009-2010 to improve logistics network for more efficient transportation of rural produce and raw materials, and increase the varieties of commodities available in rural markets - raising minimum grain purchase prices by as much as 15% since October 2008, setting up a national soybean reserve, and increasing the buying of grains, rapeseed and cotton for state reserves; increasing the subsidy for farming equipment purchases to RMB10 billion in 2009 from RMB4 billion in 2008 - providing a 13% discount for rural residents' purchases of refrigerators, washing machines, colour TV and mobile phones in coming four years, beginning 1 February 2009. More products will be added to the discount list later including air conditioners, water heaters and computers
Property market	<ul style="list-style-type: none"> - lower tax and charges, and better lending policies for home buyers - RMB900 billion to be spent on housing for urban middle and low income families. For the period 2009-2011, a total of 3.9 million units of subsidised housing for urban middle income families will be built, and a total of 6.0 million units of public rental housing will be provided to urban low income families. The two combined will account for about 2/3 of total housing supply in the coming three years
Social service	<ul style="list-style-type: none"> - RMB40 billion out of the RMB4 trillion stimulus plan to be spent on education and health care services in 2009-2010 - RMB850 billion to be spent on medical service reform in 2009-2011, of which RMB330 billion will come from the central government (RMB300 billion each for 2009 and 2010 and RMB250 billion for 2011)

Source: Takungpao, various issues; Xinhua News

Most of the measures mentioned above, however, are geared to long-term development needs and improving living standards and, hence, will take time to have any noticeable impact on consumption. However, with the Mainland's exports contracting sharply this year and possibly next year as well, private consumption is set to play a central role together with investment in driving Mainland China's economic growth in the months ahead.





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