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THE EMERGING CONSUMER ECONOMY

Is China's Growth "Unbalanced," and How Much Does It Matter?

There is little doubt that China for the last three decades has been mainly an investment-driven economy. Growth was powered by capital spending on basic industries, export-oriented factories, infrastructure, and housing. In the "expenditure" accounting that economists use to break down gross domestic product (GDP), the share of investment (technically, "gross fixed capital formation") steadily rose, while consumption's share steadily fell.¹ In 1981, capital formation accounted for 27 percent of the economy and spending by households for 52 percent. Three decades later, the investment share had soared to 46 percent—the highest figure ever recorded for a major economy—while consumer spending had fallen to just 35 percent.² About two-thirds of the increase in investment, and the decline in consumption, occurred between 2000 and 2010 (see Table 10.1).

These data have caused much confusion. Some commentary suggests that there is something wrong with China's economic model because growth has been "unbalanced," with investment growing much faster than consumption. A corollary is that Chinese consumer spending is unusually weak, and that therefore government policy should seek to boost it.

There is some truth in both these propositions, but they should not be accepted uncritically. The first one, that unbalanced growth is intrinsically undesirable, goes against the experience of post-World War II East Asia, whose growth model China has largely copied. All the countries in this region that grew rich—Japan,

Table 10.1 Investment Overtakes Consumption: Share of GDP, %

Year	Gross fixed capital formation (%)	Household consumption (%)
1981	27	53
1990	25	49
2000	34	46
2010	46	35

Source: NBS.

South Korea, and Taiwan—went through a period of "unbalanced" growth during which investment grew much faster than consumption. Because of these different growth rates, the investment share of GDP grows substantially in such periods, and the consumption share naturally falls.³

The reason for this is quite simple. To make the transition from a mainly agricultural to a mainly industrial economy, countries must install a huge amount of fixed capital: factories, infrastructure, and modern housing. During this installation process, investment spending grows very rapidly. Household incomes and spending also enjoy strong gains, as workers move from low-wage agricultural jobs to higher-paying industrial ones. But for a while, these gains do not keep up with the breakneck pace of investment. Once the "installation" phase is over, investment spending slows down, household spending becomes the main engine of the economy, and the consumption share of GDP begins to rise again. In other words, a period of "unbalanced" growth can be a perfectly natural stage for a country moving from low-income to high-income status.

Has China's "Unbalanced" Growth Been Bad for Consumers?

A simple stylized example can clarify why a period of "unbalanced" capital-intensive growth is not necessarily bad for household welfare. Imagine a poor country with a per capita GDP of US\$1,000, in which 80 percent of national income (\$800 on average) comes from farmers selling their crops. The farmers, who constitute almost the entire population, spend seven dollars out of every eight they earn

buying clothing and other necessities they cannot make for themselves. Thus in this economy, each person spends about \$700 a year, and consumption's share of GDP is 70 percent.

Then suppose this country undergoes a successful industrialization drive. During this period capitalists build factories and infrastructure, and farmers start to move to higher-wage jobs in the cities. By the end of this period about half of national income goes to the capitalists, who mostly reinvest these profits in new factories. So the household income share of the economy falls from 80 percent to 50 percent. Moreover, families now have to save one dollar out of every three they earn, because they must buy expensive urban housing, provide against medical emergencies, and have a nest egg for their old age. This means the household consumption share of GDP has fallen in half, from 70 percent to 35 percent. Per capita GDP, though, has risen to US\$10,000.

Is the average household better or worse off as a result of this process? If you look at the aggregate ratios, they seem to be worse off. The household share of national income has fallen by 30 percentage points; the average consumer only feels safe spending two of every three dollars she earns, instead of seven out of eight; and consumption's share of GDP has fallen in half.

Yet if you look instead at how much money the average consumer has to spend, it is clear that her life has improved a lot. In the old agricultural economy, each consumer spent \$700 a year. In the new industrial economy, average spending is \$3,350 a year—a nearly fivefold increase.⁴ The fact that the household consumption share of GDP has fallen by half is dwarfed by the fact that GDP has grown by a factor of ten. The reason the income pie grew so much was that intensive investment—“unbalanced growth”—created large numbers of new jobs in high-wage manufacturing sectors.

This imaginary example actually describes pretty well what has happened in China (see Figure 10.1). Between 1990 and 2013, average per capita consumer spending rose fivefold in terms of real, inflation-adjusted US dollars—an average annual growth rate of 7 percent. This was nearly double the rate of increase in the next-fastest-growing big economy (India), and far above the rates experienced by the rich economies and by middle-income countries in Latin America. This explosive growth in consumer spending occurred even as the consumption *share* of the economy fell by about

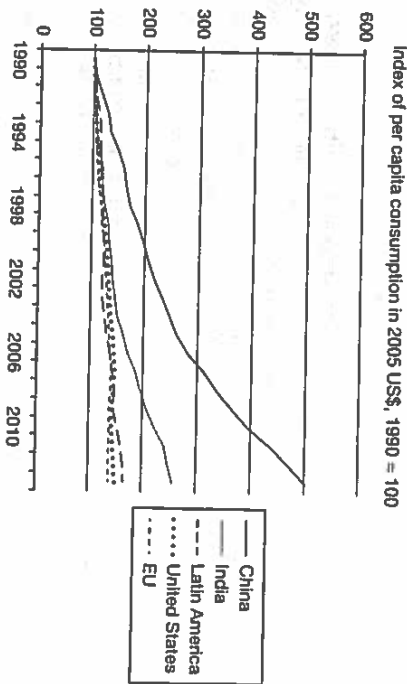


Figure 10.1 Rise of the Chinese Consumer
Source: World Bank.

15 percentage points, and as the household saving rate rose from about 20 cents of every dollar of income to 30 cents. The spending power of consumers in China's “unbalanced” economy grew much faster than that of consumers living in more “balanced” economies.

The new spending power of Chinese consumers is visible in a wealth of particular examples. Here are two. First, China became the world's biggest passenger-car market in 2010, and annual sales of nearly 20 million units are now about 30 percent higher than in the United States. Second, Chinese consumers are increasingly taking their money abroad. China surpassed Germany as the world's leading source of international tourist trips in 2012, and by 2014 it recorded over 100 million such trips, five times the number a decade earlier. Spending by Chinese international tourists was \$165 billion—eight times the figure in 2004.

Of course this does not mean that the only way for a country to grow rich is through intensive investment, or that all investment is a good thing. China's pre-1980 period, and the history of the Soviet Union, provide examples of investment-intensive economies that did not lead to vibrant consumer spending. This was because those economies invested mainly in heavy industries like steel and petrochemicals, deliberately suppressed production of consumer goods,

and failed to achieve the productivity gains needed for sustained wage growth.

Nor does it mean that China's situation today is without flaws. Far from it. The capital spending share of GDP is extraordinarily high, even for an East Asian economy; returns on investment have been falling since 2008; and evidence of wasted investment is everywhere in "ghost cities," empty shopping malls, and factories churning out more steel, cement, and glass than the nation can absorb. Perhaps more important, China's capital-intensive stage of growth created far more income inequality than was the case in Japan, South Korea, and Taiwan. The society China has created is quite a bit less fair than its East Asian models.

It is clear the investment-heavy phase of growth is nearing its end, and in the future the economy will have to be driven by consumer spending and by more selective, high-return investments. We will explore this future "rebalancing" from an investment-led to a consumer-led economy further in chapter 12. For the moment, it is enough to observe that China's consumer spending has in fact grown very rapidly for many years. From a policy perspective, the task of "rebalancing" has less to do with boosting consumer spending—which is already doing fine on its own—than with increasing the efficiency and productivity of investment, and ensuring that the profits from capital are properly taxed and redistributed into appropriate social goods.

Why Is the Consumption Share of China's Economy So Low?

This unfortunately is a technical question to which there is no definitive answer. According to official data, household spending in 2013 was just 36 percent of GDP. Virtually every other major economy in the world has a household consumption rate of 50 to 65 percent of GDP.⁵ As we have just argued, China's low figure does not indicate that consumption is weak; in fact it is quite strong. What it mainly shows is that China's investment boom was unusually large: consumer spending grew very fast over the last quarter-century, but investment spending grew even faster.

A couple of other factors are at work. One is that consumer spending is almost certainly undercounted. This reflects the bias of the Chinese statistical system. Because economic policymakers

are mainly concerned with promoting investment and industry, the data on investment and industry are detailed and accurate. The data on consumer spending, wages, and services are of much lower quality, and almost certainly miss a lot of activity. It is increasingly accepted that Chinese consumption data understate the true value of housing services, and probably miss much spending on transport and leisure as well.⁶ Plausible upward revisions of these sectors produce a consumption ratio of 40 percent—still low, but not as dire as the official figure. Some Chinese economists have argued, with weaker evidence, that the true consumption ratio may be as high as 45 to 50 percent, or at the low end of the normal range for a country at China's stage of development.⁷

Another point often overlooked by analysts is that China's present low consumption rate is in part an artifact of its unusually low consumption rate at the beginning of economic reforms. When Japan started its most investment-intensive stage of growth, in 1955, household spending was 66 percent of GDP, the comparable figures for Taiwan and South Korea were 62 percent and 71 percent. After a decade or more of heavy investment, these ratios all fell into the low 50s before gradually recovering. But at the beginning of China's reform process in 1980, the consumption ratio was *already* barely above 50 percent. Most likely this reflects the structure of the planned-economy period, when consumption was deliberately suppressed in favor of large-scale state investments in heavy industry. Although that economic structure gradually disappeared, influential vestiges remain, such as the tendency of some urban consumer spending to come in the form of in-kind benefits from work units (gifts of food at the Lunar New Year, all-expenses-paid company outings, etc.). This again supports the notion that true consumer spending is likely to be higher than is shown in official statistics.

What Is China's "Middle Class"?

When we talk about Consumption with a capital "C" in China, we mainly refer to the spending of the urban middle class. About half of Chinese still live in the countryside, working mainly in farm-related activities, and of course they account for a large share of purchases of basic necessities. But their incomes are low: the average

rural household has the same income as one in the poorest 10 percent of urban households. So the bulk of consumer spending in the “modern economy”—purchases of branded consumer goods, and of transport, leisure, finance, education, and healthcare services—is done by urban households.

Before trying to pin down how many people are in this urban consuming class and how much money they have to spend, it is worth clarifying the term “middle class.” Although the words imply a group of people in the middle of a country’s income distribution, the term is generally used in a much fuzzier way. It refers to the group who share certain characteristics broadly considered typical of the mainstream of people in a modern urbanized economy. They work for a living, in jobs that pay them enough so that they can buy their own house, a car, and other consumer durables like televisions, computers, and air conditioners. They invest significantly in education, and usually hope their children will work at white-collar jobs rather than on a factory floor. And because they typically own property, they pay a lot of attention to ensuring that their property rights are secure.

China has many such people, but we should bear in mind two characteristics that distinguish the Chinese “middle class” from the “middle class” in developed countries: First, the Chinese middle class is neither the middle nor the majority of society. Below we will offer a generous estimate that the middle class comprises about one-quarter of the national population, enjoying incomes in the upper third of China’s income distribution. In other words, the people with a middle-class lifestyle in China constitute an elite, rather than a majority “middle class” in the American or European sense. This has an important political implication: the Chinese middle class is unlikely to become an advocate for political change anytime soon, since it is a privileged minority that benefits disproportionately from the present system.

The second characteristic is that one can qualify as a member of the Chinese middle class with an income far lower than that required for middle-class status in the United States, Western Europe, or Japan. So when we start looking at the size of China’s middle class, it is important to remember that, on average, Chinese middle-class people have less spending power than middle-class people in developed countries.

How Big Is the “Middle Class”?

There are as many estimates of the size of China’s middle class as there are consulting firms with consumer-goods clients. As we have just shown, “middle class” is an amorphous concept, so it can be plausibly defined in many ways, producing estimates of widely differing size. Bearing this caution in mind, we offer two calculations that define the upper and lower bounds.

The first is that of the World Bank, which defines the middle class in all countries as the people who spend US\$10 to \$100 each day on consumer goods and services. On this definition, the World Bank calculated China had 157 million middle-class consumers in 2010, or about 11 percent of the population. This was a large increase from just 2 percent in 2000, but considerably lower than the middle-class share of the populations in Brazil and South Korea when those countries were at China’s present level of development.⁸ Simple extrapolation suggests that by 2015, about 15 percent of China’s population (roughly 200 million people) qualified as middle class according to the World Bank’s standard.

A broader calculation relies on well-established income thresholds at which people in most countries start to buy important categories of goods and services. Households with incomes of at least \$8,000 a year start to buy brand-name goods rather than cheap knock-offs. At \$13,000 a year they start to buy automobiles—and since purchases of cars and houses are tightly correlated, this is also roughly the threshold level for widespread home ownership. At \$20,000, they become significant purchasers of modern services: healthcare, education, tourism and leisure, and financial services.⁹ If we define home ownership as an important criterion for a middle-class lifestyle, the middle class consists of households with an income of at least \$13,000. We can define a larger “consuming class”—that is, people who are already active purchasers of some consumer goods, and may soon graduate to a middle-class lifestyle—by including all households whose income is at least \$8,000 a year.

By this measure, China had a middle class of about 330 million people in 2012—one-quarter of the national population. (The narrower group of people we call “affluent” in the table below, with a household income of at least \$20,000, roughly corresponds to the World Bank’s definition of the middle class.) In addition, there were

Table 10.2 How Big Is China's Middle Class? Estimate for 2012

Income bracket	Millions of people	% of national population
Affluent	173	13
Established consumers	155	11
"Middle class"	338	24
Emerging consumers	228	17
Total consumer class	556	41
Lower incomes	805	59

Definitions:
 Affluent: in households with income above \$20,550
 Established: household income between \$13,500 and \$20,550
 Emerging: household income between \$8,100 and \$13,500
 Lower incomes: household income below \$8,100

Source: Adapted from Galley 2013.

about 230 million "emerging consumers" with the potential to break into the middle class within the next decade. (See Table 10.2 for a full breakdown of the estimates of China's middle class.)

In short, depending on one's definition, one can say that the Chinese middle class is somewhere between 200 million and 300 million people, or 15 to 25 percent of the national population. At the high end, China's middle class is almost as big as the population of the United States—but has a median income far below the US median household income of \$53,000 a year.

What Do China's Consumers Buy?

Over the past few decades, China's urban consumers have gone through successive waves of buying trends. In the 1980s, when incomes were very low, people focused on things like bicycles, electric fans, and basic furniture sets. In the 1990s they started to buy pricier household goods such as washing machines and air conditioners, and by the end of the decade China became the world's fastest-growing cell phone market. The early 2000s brought a huge upsurge in purchases of automobiles, and the private housing boom

created large new markets for home furnishings and appliances. The average shopping basket for "affluent" Chinese consumers (the 13 percent or so of the population whose household income is above \$20,000) is now fairly similar to that of ordinary households in South Korea and Taiwan.

One important shift is the rapid adoption of online commerce. E-commerce still accounts for just 5 percent of all retail sales—up from near zero as recently as 2009—but in some categories the online share is much higher. More than 20 percent of appliances and consumer electronics, and around 15 percent of clothes and cosmetics, are now bought over the Internet.¹⁰ The retail landscape of Chinese cities will remain a hodgepodge of traditional markets, where most people still prefer to buy their fresh produce; modern supermarkets, department stores, and shopping malls, which offer a valued social experience; and online shopping. But e-commerce will certainly see the fastest growth. The potential growth of the market was reflected in the September 2014 initial public offering of China's biggest e-commerce firm, Alibaba, which valued the company at over \$230 billion—significantly more than Amazon, even though Amazon's annual sales are about ten times Alibaba's.

There are several reasons for this swing. One is that the government has invested heavily to ensure that Internet access is cheap and virtually universal in urban areas: an estimated 650 million Chinese had Internet access in 2014, a sevenfold increase from a decade earlier. China is also home to a plethora of hardware manufacturers offering low-cost computers and smartphones. A Chinese firm, Lenovo, has the largest share of global personal-computer sales, largely because of its command of the China market. Lenovo and two other Chinese firms, Huawei and Xiaomi, are the world's third- through fifth-biggest suppliers of cellphones (behind Apple and Samsung), again because of their popularity in China.¹¹ Another factor is that an abundance of low-cost labor made it possible for e-commerce companies to hire armies of delivery people, who roam the cities on electric bicycles and motorbikes, delivering most goods within one or two days after an online order is placed.

Aside from the rise of e-commerce, the biggest trend in Chinese consumer behavior—and one with greater macroeconomic significance than online shopping—is a sharp rise in consumption of

services. As we noted above, service consumption begins to pick up sharply among households making more than \$20,000 a year. Such households have already satisfied their main material needs, and devote an increasing share of their income to extras like leisure and tourism; additional spending on education for their children (or perhaps even for themselves); more expensive healthcare; health and retirement services for their parents; and financial services to generate a higher return on their savings than that afforded by bank deposits.

This is important because, since 2010, the fastest-growing income bracket among China's consumer classes has been the "affluent" (\$20,000-plus) category. And it is likely that most of the increase in Chinese consumer spending over the next decade will come from this group.¹² As one might expect, the last few years have seen a dramatic rise in service consumption. Overall, the services share of GDP rose from 43 percent in 2010 to 48 percent in 2014, and the service sector is now larger and growing faster than the traditional growth engines of industry and construction.

This growth is broad-based. We noted above the big increase in Chinese international tourism, which followed an even larger rise in domestic leisure travel. The boom in "wealth management products" around 2010, which we described in chapter 7, clearly reflects the emergence of a critical mass of high-end households that already owned property and were hungry for ways to diversify their financial portfolios. Between 2005 and 2013, the number of hospital beds nationwide rose by 75 percent, after nearly two decades of stagnation, and total healthcare spending rose from 4.5 percent to 5.2 percent of GDP.

How Good Is China's "Social Safety Net" and Would Making It Stronger Help Consumption?

Much discussion of consumption in China has focused on the relative lack of a social "safety net": public programs for health insurance, unemployment insurance, pensions, and so on. A common story is that consumer spending in China is relatively weak because families feel compelled to engage in "precautionary saving," devoting an ever-larger share of their income to finance expected future healthcare, education, and retirement costs. The evidence for this

story is that the household savings rate has risen from less than 20 cents for every dollar of disposable income in the late 1990s to around 30 cents today. An improved social insurance system is therefore an important precondition for a more robust consumer economy.

This story sounds plausible. The traditional social safety net for urban workers until the late 1990s came through state-owned enterprises, which provided guaranteed employment, housing, medical care, pensions, and schooling for employees and their children. This welfare system was dismantled by the SOE reforms of 1995–2005, and at first there was no replacement for it. Urban families had to buy their own housing, and increasingly paid medical expenses and school fees out-of-pocket. Rural families suffered in different ways. Their main traditional safety net was simply the family farm, which could provide a subsistence living if all else failed; and this was unaffected. But the availability of state-provided medical care in rural areas deteriorated sharply in the 1990s.

These failures of government social welfare spending coincided with a rise in the household saving rate, and a decline in the consumption share of GDP. So it was natural to conclude that lower welfare spending contributed to weaker consumption, and that strengthening the social safety net would boost consumer spending. On closer inspection, the argument does not really hold up.

For one thing, growth in household consumption began to accelerate just as the old social safety net fell apart. In 2001, the trend growth rate in per capita consumer spending was just 5.6 percent a year; by 2008, when new social programs had been launched but not yet fully funded, this figure had risen to 7.6 percent. By 2013 trend consumption growth had climbed to 8.4 percent, even though the household saving rate continued to rise.¹³ This acceleration is not consistent with the "precautionary savings" story. But it does square well with the story we told earlier in the chapter, about how rapid industrialization can create large income gains that enable the average consumer to spend a lot more dollars each year, even as she saves a higher percentage of each dollar she earns.

Another interesting point is that, at least in their early stages, expensive social welfare programs are more likely to be negative than positive for household incomes. This is because they have to be funded, and the main source of funding is levies on employers and employees that fall disproportionately on workers. Once a welfare

system is up and running, present workers can benefit from the contributions that earlier workers made into social security funds. But the first generation of workers enjoys no such benefit. Moreover, the largest share of healthcare and pension benefits goes to older retirees. Today China has about five people of working age for every one of retirement age, meaning that more people are paying into social welfare funds than are extracting benefits. This is obviously good in the long run, but it is hard to see how it could be beneficial for total consumer spending in the short run.¹⁴

The conclusion is that creating a social safety net is likely to have a modest impact at best on consumer behavior, especially during the period when households are putting more into the welfare system through tax payments than they are receiving in benefits. Much more important is the rate of income growth. If household income grows fast, so will consumer spending, even if the safety net is riddled with holes. A social safety net is an important component of a just and equitable society, but it is not a consumption policy.

What Sort of Safety Net Is the Government Weaving?

One of the significant achievements of the Hu Jintao administration was the establishment of a comprehensive set of nationwide social programs, replacing the old SOE-based welfare system. In addition to expanding the minimum-income program that ensures a basic livelihood for the poor who are unable to find work, Hu's government established separate nationwide health insurance programs for urban and rural residents; abolished tuition and other fees for the nine years of education that are compulsory under Chinese law; greatly expanded coverage of basic pension schemes; and began a large-scale program to subsidize housing for low-income urban residents.

The minimum income program began in 1997 as a measure to prevent laid-off SOE workers from falling into destitution. In 2007 it was extended to include poor rural families, and about 3 percent of the urban population and 8 percent of the rural population are beneficiaries. Comprehensive national health insurance began to be rolled out in 2009 and consists of two urban insurance schemes (a mandatory one for formal-sector workers, funded mainly by employer and employee contributions, and a voluntary one for

informal-sector workers, which relies more on government subsidies) and one for rural residents. At least 95 percent of households, both urban and rural, are now covered by government health insurance. However benefit levels, though rising, remain very meager. The number of people covered by government pensions has risen to about 700 million, from 200 million in 2002, although again the benefit levels in most cases are very basic. Another important initiative was the establishment of "social housing" programs in 2010 in order to increase the availability of affordable housing for low-income urban households. Between 2005 and 2013, total government spending on health, education, and social security rose from 5 percent to 8 percent of GDP, and from 28 percent to nearly 33 percent of the government budget. These figures would be even higher if subsidies for social housing were included.¹⁵

These achievements are substantial, but it is obvious that much more needs to be done. Many urban and rural workers still need to be brought into the pension system, and benefit levels for both pensions and health insurance must be raised significantly. More important, most social programs do a poor job of covering the migrant workers who constitute as much as a third of the urban population. Extending coverage to these disadvantaged workers, and financing increased benefits, will be very hard. A particular difficulty is that benefit levels must be raised to make them meaningful—but not raised so much that they impose an unbearable fiscal burden in thirty to forty years when China becomes a much older society, with far fewer workers supporting far more retirees. Yet solving the social welfare puzzle is essential if China is to bridge the vast gulf of income and social inequality that has arisen as a result of the fast economic growth of the past three decades.

What Policies Should the Government Take to Promote Consumption?

Earlier we made the point that the government need not bend over backward to boost consumer spending, which has been growing quite robustly for many years. We also argued that expansion of the social safety net, while important for other reasons, is unlikely to have much impact on consumer spending, at least in the short run. Does this mean the government should do nothing to make the economy more consumer-friendly? Not at all. There are two broad

policy areas where the government can reasonably act to increase the scope for a vibrant consumer economy to emerge.

The first relates to income distribution. The main reason that household consumption is such a small share of the economy is not that consumers are reluctant to spend, but that the household share of national income is relatively small. The best way to get households to spend more is to increase their incomes.

As one would expect during an era of capital-intensive industrialization, an increasing share of national income over the past fifteen years has gone to companies that have reaped large profits from their investments, and mostly reinvested those profits in more industrial capacity. A goal of economic policy should now be to ensure that this trend is reversed, and that the household share of national income starts to rise. There are several ways to do this. Increased environmental and resource taxes can reduce corporate profits that arise simply from ignoring the true costs of "externalities" such as environmental damage or resource depletion. Allowing the cost of capital to be determined by the market, rather than by government policy, will effectively raise costs for heavy-industrial firms (especially SOEs). This means that firms will have to make their investments more efficient; it will also encourage them to simply forgo new investments when the prospective returns are not high enough. Then, instead of constantly recycling profits into new investment, they may choose to return some of their profits to shareholders through higher dividends; and that money becomes available for consumption spending. Ensuring stronger competition will also tend to reduce corporate profits; consumers benefit through lower prices, and will have more money left over to spend elsewhere.

The second major area where government policy can be useful is in promoting the development of services and deemphasizing industry. A shift from industry to services tends to redirect income away from the corporate sector and into households, because services generally use much more labor and much less capital than does industry. So a higher share of a service company's revenue goes into workers' pockets, in the form of wages.

Most of these initiatives have been built into government policy, at least in theory. The twelfth Five-Year Plan (2011–2015) explicitly targeted raising the household share of national income, and it

also embraced the aim of making services replace industry as the main driver of economic production. Under its Third Plenum policy agenda of 2013, the Xi Jinping government has moved to raise resource taxes, make the pricing of capital more market-driven, and increase competition. Another bit of good news comes from demographics. As we documented in chapter 9, the supply of young workers is shrinking rapidly, forcing employers to raise wages more sharply than in the past. A number of market and policy factors are thus conspiring to give households a bigger share of national income, and this should be beneficial for consumer markets in the future.

Unfortunately, there are also a lot of obstacles. Much of the bias toward industry and investment arises from incentives built into the fiscal system, so a great deal depends on the ability of the central government to push through its very complex fiscal reform plan. Corporations (both state-owned and private) and officials at all levels of government profit handsomely from the present system, and will fiercely resist the necessary reforms. The next two chapters will examine in more detail the costs of the present growth model, and what the government needs to do to change it.