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China's Next Leap Forward—Economic Rebalancing and Structural Adjustment (Part 3)

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In our last report, we argued that recent evidence of China's economic rebalancing largely boils down to cyclical factors and that the effect of structural changes to date has been relatively limited. In this issue, we focus on the structural policies we think China needs to create a consumer sector comparable to those of other major world economies.

In Hong Kong, where *Asian Perspectives* is based, it is difficult not to feel the power of China's growing consumerism. Mainland Chinese tourists have flooded this southern enclave and now account for almost two-thirds of total visitors annually. Over the past few years, their strong purchasing power for branded and luxury products has completely reshaped the city's retail scene. Flagship stores of global branded goods are now ubiquitous, but their target market consists not of local shoppers but the cash-rich visitors from north of the border. Per-capita overnight spending by mainland Chinese tourists averages US\$850, some 30%–40% more than that of their American and European counterparts.

Without doubt, the past three decades of economic modernization in China have produced an emerging class of consumers. That said, the 18 million Chinese big spenders coming to Hong Kong every year represent only a fraction—or slightly more than 1%—of China's 1.33 billion population, and they are the beneficiaries of China's uneven income expansion. From a macro

point of view, however, the country's consumption picture looks much less robust.

Beijing Should Boost Wages While Also Tackling High Saving Rate...

As **Display 1** shows, wages or employee compensation in China are declining as a share of GDP; this is quite unusual in a country that has experienced a prolonged period of rapid economic growth and has been the prime cause of the falling consumption ratio (also shown). Rising household saving, particularly among urban dwellers (**Display 2**), has put further pressure on the consumption ratio. To unleash consumerism, therefore, Beijing must implement a double-whammy policy of boosting workers' income while also vigorously pruning the high national saving rate of around 50%.

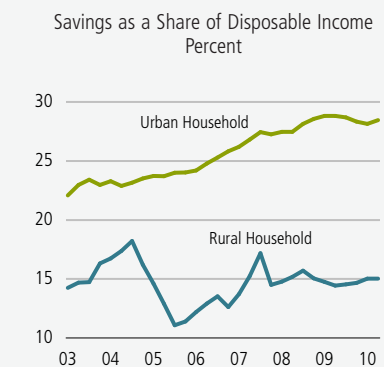
To date, Beijing has focused on encouraging households to spend as a way of reducing savings, but the recent surprise approval of various levels of minimum wages across the country suggests that policymakers are also becoming more

Display 1
Falling Wages and Rising Savings Curb Consumption



*This series is estimated from China's flow of funds data which are available only up to 2007.
Source: CEIC Data and AllianceBernstein estimates

Display 2
Urban Households' Saving Rate Is Rising



Source: CEIC Data and AllianceBernstein estimates

determined to tackle the issue of low labor compensation. Raising wages is a key to

kick-starting China's restructuring, and the establishment of a minimum-wage structure has at least set a base for labor reform. Uncertainty remains, however. In our view, the key question is whether a tighter labor market will be powerful enough in itself to trigger an increase in labor compensation's share of GDP if, as some skeptics have argued, China still lacks two very important components of structural change.

...but Institutional Hurdles Stand in Way of Raising Wages' Share of GDP

First, the political reality is that controlling elements within the Chinese Communist Party are unlikely to allow the emergence of well-organized labor unions to bargain for workers' wages. The specter of widespread labor strikes or unrest and the associated threat to social and political stability will continue to dominate Beijing's thinking in this respect. Second, the flip side of falling labor compensation as a share of GDP is the increase in the share of profits in China's national income. In a market-based economy, higher profits should eventually boost wages and salaries and, consequently, consumption.

In China, however, state firms still largely dominate many aspects of the economy, although their influence has been waning for the last 20 years or so. For example, state and government-related enterprises still accounted for half of China's total industrial production last year, despite the 30–40 percentage-point drop in their shares since the early 1980s. This explains why rising profits in China have been associated with a rising investment ratio, as profits have been largely recycled for investment and capacity expansion. Moreover, the absence of dividend payouts by many state firms has exacerbated the disparity between profits and labour compensation. The point is that, while wages will certainly rise with national income, whether they will grow significantly and make a growing contribution to future consumption will very much depend on the political will at the top to opt for genuine institutional change in

these two key areas.

Pension and Social Welfare Reforms Are Key to Lowering Saving Rate

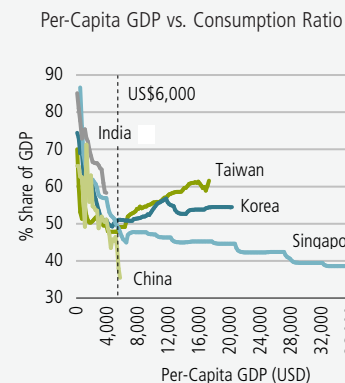
For the time being, at least, Beijing is expected to tackle the high household savings problem by improving the pension and social welfare systems. The jump in China's saving rate since 2000 is a direct consequence of the state enterprise reforms and downsizing of the 1990s. The schools, medical facilities and social welfare that 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.

As part of last year's RMB4 trillion fiscal package, Beijing has already earmarked some RMB850 billion (US\$125 billion) and RMB300 billion (US\$44 billion) 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 deeper penetration of the national pension scheme among 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. Obviously, China has much to do to bridge the gap, but the grand plan is to create an equitable and universal healthcare system by 2020. The administration 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

Display 3

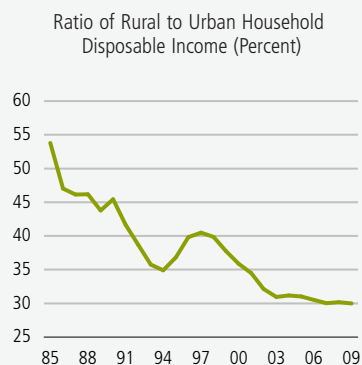
Wealth and Consumption: The Asian Experience



Source: CEIC Data and AllianceBernstein estimates

Display 4

Income Disparity Grows



Source: CEIC Data and AllianceBernstein estimates

coverage (the government aims to add 200 million migrant workers to the scheme) and reduce individuals' precautionary savings. Currently, only 17% of migrant workers have joined the non-transferable local pension scheme.

Consumer Finance: China Should Avoid Repeating South Korea's Mistake

Some optimists have argued that the time is right for China to transform itself into a consumption-driven economy. There is global evidence to suggest 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 a

reasonably high level—around US\$6,000 in purchasing power parity (PPP) terms, according to some views—structural changes take effect: the consumption ratio bottoms and starts to climb while the reverse occurs to the national investment rate.

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. The good news is that China's per-capita GDP (in PPP terms) is approaching the threshold level of US\$6,000. We have tested the experience elsewhere in Asia: the result is positive for Taiwan, less so for South Korea and not at all for Singapore (**Display 3, previous page**).

In South 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.

If policies are correctly implemented, we think China's development should 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 South Korea's mistake—a pertinent comment in view of Beijing's decision last year 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.

Freeing Rural Workers to Move to Cities Is Good for Consumption...

China has been using the urbanization drive (from an urbanization rate of 20% in the early 1980s to the current 50%) to sustain high economic growth, and urbanization in itself—which involves the migration of residents from rural to urban areas—should, in theory, drive consumption growth since living expenses in the cities are far higher than on the farms. The failure of urbanization to boost the consumption ratio lies largely, as discussed above, with high savings and inadequate pension and social welfare protections. Another factor has been China's rigid household registration (Hukou) system. The system deprives rural migrants of access to public healthcare, social welfare and education for their children if they abandon state-granted farmland to move to the city.

The good news is that the state has already started to liberalize the Hukou system, and pilot programs have been introduced recently that allow rural households to keep their entitlements to these benefits when they migrate to cities within the same province. We expect that such a change will eventually extend to rural migration across provinces. The outcome will be an acceleration of urbanization as migrant workers can bring their families and children to live in the city. This will be positive for consumption.

...as Is Removing Obstacles to the Sale of Rural Residential Land

Equally important, China needs to directly boost the income of its 700 million rural

residents so as to reduce the risk of social unrest in rural areas where incomes are increasingly falling behind those of affluent city dwellers (**Display 4, previous page**). Crucial to this policy is the need to find a way for rural households to monetize their land-use rights. This is a fundamental and politically sensitive issue in China. If not handled properly, it would exacerbate the growing inequality between two classes of citizens. Urban dwellers have the right to own properties and gain from asset appreciation, while rural people are locked into their half-hectare of farmland given to them for basic livelihood by the Communists when they took over in 1949.

At the third plenary session of the 17th Party Congress in 2008, the leadership seemed to break out of its ideological constraints with the announcement of several key fundamental changes to deepen rural reform. Permission was given for the transfer of agricultural land-use rights and the trading of rural residential land. In our view, this was a belated but important acceptance of the privatization of farmland by China's socialist regime. Although the change will not be swift and bold, pilot programs have been gradually introduced as a prelude to the reform of land-use rights being introduced across the country. If the policy is implemented well, we expect it to have two important effects on rural incomes.

First, we expect a secondary market for the sale and purchase of rural land to emerge, supported by much-needed reforms to rural finance, which will lead to a one-off transfer of wealth to rural people. This will provide a direct boost to consumption. Second, the merger of arable land through sales or rentals will also create greater incentives for farmers to upgrade production techniques for large-scale farming. This will lead to higher capital investment, productivity, output and, thus, incomes and consumption.

Indeed, the combined result of the above two changes—the sales of farmland and

the growing replacement of rural labor by machines—will further accelerate rural migration, thereby speeding up China's urbanization. It should be remembered that, even after three decades of rapid industrialization and urbanization, China's rural residents' share of total population remains substantial: in 2009, it was 53% (713 million) compared to the less than 10% share among major fully industrialized countries. Obviously, China still has a long way to go to reach that level, but the rural reform policy will undoubtedly accelerate the process.

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 and European counterparts. China's private consumption expenditure was around US\$1.8 trillion in 2009, which accounted for half of non-Japan Asia's total spending and was some two and a half times bigger than India's, the region's second biggest spender. However, China's consumer spending was still slightly less than one-fifth of the US's and about one-fourth of the EU's. As such, even assuming continued rapid future growth in China, it will probably take two decades for the size of its consumer market to match that of the US or Europe.

We believe, however, that the important investment implication is not the absolute size but the incremental change in consumption. Chinese consumers spent almost US\$200 billion more in 2009 than the prior year, which had helped offset the shrinkage in spending in the US and Europe during the global crisis. 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 5**).

Uncertainty Remains

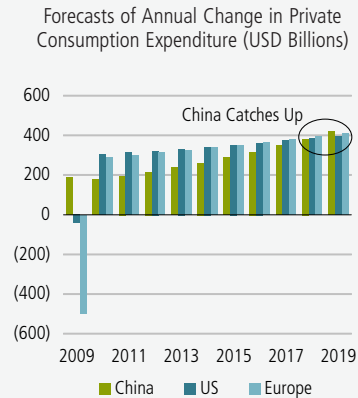
This forecast is not without qualification,

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 home grown brands as much as foreign. 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. This also leads to a more profound question on whether the rebalancing of China's domestic demand from investment to consumption will result in a much smaller external surplus in the long run. It did not happen to Japan and most of Asia's advanced economies during their transformation process (influenced, of course, by their own institutional factors).

That said, a meaningful revaluation of the Chinese renminbi over the long run would be a necessary and important factor in helping to trigger the external rebalancing process. The import elasticity of China's consumption should increase since an appreciating currency would boost the buying power of local consumers. At the same time, exchange-rate appreciation together with a growing domestic consumer market should increase the incentive for Chinese manufacturers to sell locally rather than—as witnessed over the past decade—simply flooding the overseas markets with their products. If the policy transition is effective, the end game of China's domestic-demand rebalancing should result, in our view, in less reliance on export-driven economic growth (and, thus, a reduced external surplus).

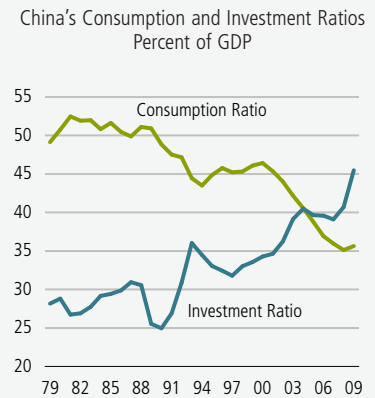
Moreover, another important point, which is often incorrectly perceived, is that it is not the case that China lacks consumer spending and therefore requires government action to spur it. China's real private consumption growth averaged 9% a year over the past 10 years—one of the strongest performances in the world. All the structural measures discussed above may

Display 5
China Will Be the Fastest-Growing Consumer Market



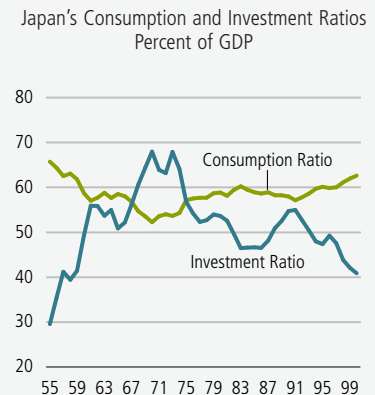
The forecasts assume China's consumption growth (in nominal USD terms) will average 10% p.a. (vs. 13% p.a. in the past 10 years), US's growth at 3% p.a. (vs. 5% p.a.) and EU's growth at 4% p.a. (vs. 6% p.a.).
Source: CEIC Data and AllianceBernstein forecasts

Display 6
China's Investment Ratio Will Need to...



Source: CEIC Data and AllianceBernstein estimates

Display 7
...Resemble Japan's During 1970s Transformation



Source: CEIC Data and AllianceBernstein estimates

help sustain the already strong growth trend rather than double its pace. So, on this basis, what is really needed for the consumption ratio to rise is a fall in the exceptionally high investment ratio (or a decline in net exports). And this will require China to slow the real growth of fixed investment, which is unsustainable at a hefty annual average of 13% over the past decade. Similar structural shifts in consumption and investment have occurred in South Korea since the 1990s and Japan's experience in the 1970s and 1980s seems to be the most relevant to China (**Displays 6 and 7, previous page**).

In our next commentary, we will focus on the structural changes in China's investment, and how improvements in economic efficiency and production value-added may help achieve a lower investment ratio in the long term.

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