

# CHINA BALANCE SHEET

## CONSUMPTION-LED GROWTH

The direction that China and U.S.-China relations take will define the world's future. For the United States, a rising China increasingly affects American prosperity and security, calling for some clear-eyed thinking and tough economic, political, and security choices. As the twenty-first century unfurls, the stakes have never been higher for getting U.S. policy toward China right. By untangling the complex, sometimes contradictory, strands of this vast and dynamic country, *China: The Balance Sheet* lays the foundation for informed and effective U.S. policy toward China, the world's emerging superpower.

### BACKGROUND

- Over the past few years, China's economic growth has become increasingly dependent on increases in investment and net exports.

### CURRENT SITUATION

Policies for consumption-led growth:

- **The usual path to increased consumption is fiscal stimulus in the form of tax cuts on household income.** This avenue is of limited relevance in China, where direct taxes on households are only 1 percent of GDP.
- **The alternative form of fiscal expansion is an increase in government expenditures.** Given already high levels of investment and the emergence of excess capacity in many industries, however, the Chinese government needs to increase its noninvestment outlays, notably those on health, education, welfare, and pensions – those programs on which government at all levels currently spends only about 3.5 percent of GDP.
- In the short run, however, success may be hard to achieve. First, **since current government non-investment expenditures are so low, even dramatic proportional increases would increase consumption as a share of GDP only modestly.** Second, quantum jumps in such expenditures may not be feasible, at least not right away.
- **Increases in China's private consumption expenditure will thus disproportionately depend on reducing the extraordinarily high savings rate of households,** which has been running at about 25 percent of disposable income since 2000.

For further information, see Chapter 2:

“China's Domestic Economy: Continued Growth or Collapse?”

*China: The Balance Sheet: What the World Needs to Know Now about the Emerging Superpower*

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- Yet, this is a formidable task in China, because the motivation for household savings seems primarily precautionary. **Only about one-seventh of the population, for example, is covered by basic health insurance, so many households save to cover medical expenses.** Families also save for retirement because the basic pension scheme covers only about 16 percent of the economically active population -- and in any case provides a pension equal to just 20 percent of average wages. Finally, **households save for education. Primary school fees are a large financial burden, particularly for poorer rural households.**
- **In the long run, as families gain confidence in the government's provision of health, education, and other social services, they may reduce their own savings voluntarily,** i.e. increase consumption as a share of their disposable income. Thus, the transition to a more consumption-driven growth path will probably need to start with increased government consumption expenditures, but with time is likely to be reinforced by changes in household consumption and savings decisions.

## IMPLICATIONS

- China emerged in 2006 as the largest global surplus country—and thus has become, along with the United States, a major source of global economic imbalances.
- Parallel actions by China and the United States, respectively the most important countries with unusually high and low savings rates, could significantly reduce these imbalances.
- **If China's households reduce their savings rate, China's current account surplus will decline.** This adjustment should be facilitated by an appreciation of the Chinese currency, which would mitigate the inflationary pressures that otherwise might emerge as savings' share of income falls and the share of consumption rises.
- Meanwhile, **there would need to be a simultaneous upward adjustment of the U.S. savings rate -- either through a reduction of the federal government fiscal deficit or an increase in household savings.** The latter would most likely result from a cooling of the housing market, which has fueled high consumption expenditures in recent years.

### Investment vs. Consumption in China

- *As early as December 2004, the Chinese Communist Party recognized the need to adjust the relationship between investment and consumption as sources of economic growth.*
- *In mid-2005, the central bank refined this theme, arguing that investment growth needed to slow further to allow demand to catch up with supply in sectors such as steel, aluminum, cement, real estate, and even electric power, where excess capacity was evident or predictable.*
- *The bank also doubted the sustainability of rapid net export growth, if for no other reason than the likely rise of foreign protectionism, and concluded that China needed to transition to a more consumption-driven growth path .*
- *This objective has since been reprised in a number of important government documents and by Premier Wen Jiabao in speeches to China's national legislative body in the spring of 2006 and 2007.*
- *While it may take time, such a transition would be a welcome development for the United States and the global economy.*