Economist.com .gif" WIDTH="326" HEIGHT="34" VSPACE="3">

The frugal giant

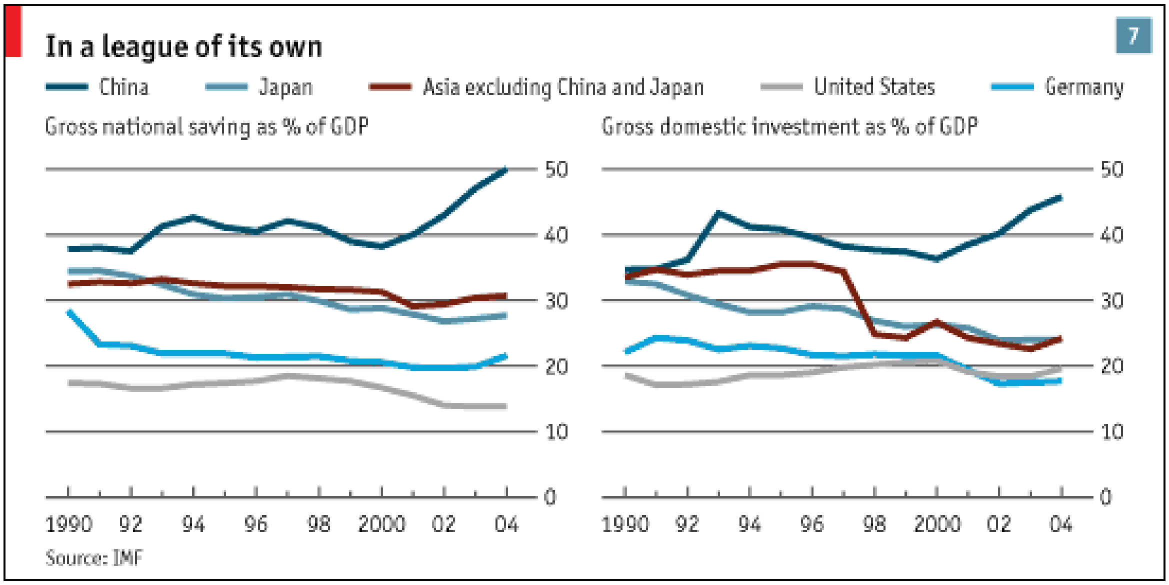
Sep 22nd 2005
From The Economist print edition

China's enormous saving surplus may rise further before it falls

IN THE Haidan district of western Beijing stands the world's biggest shopping mall. Six storeys high, with 230 escalators and over 6m square feet (558,000 square metres) of retail space, it is a temple to consumption. Over 1,000 shops sell everything from clocks to cats; the “Fantawild Hitech Family Funplex” offers entertainment; an ice-rink beckons.

Only one thing is missing: customers. On a weekday morning in early July, the place was virtually empty, and such visitors as there were seemed to be window-shopping rather than buying. Like the rest of the world, the “Golden Resources Shopping Mall” is still waiting for a big Chinese consumption boom.

Thanks to rocketing economic growth, the Chinese are spending a lot more than they used to. There are now 59 washing machines per 100 households, up from one in 1985. The number of Chinese travelling abroad rose by 43% last year, to 29m. But Chinese saving is growing even more rapidly. Since 2000, the country's overall saving rate—already the world's highest by far—has risen sharply, to nearly 50% of GDP (see chart 7). Even though China is investing at the staggering rate of 46% of GDP, it is still running a net saving surplus, and that surplus is still growing. It rose from 1.9% of GDP in 2000 to 4.2% in 2004, and shows no signs of stopping.



Noting that imports have recently been subdued, many China-watchers expect the country's current-account surplus to rise to 7% or even 8% of GDP in 2005. China may still be poor, but it has become one of the world's biggest exporters of capital. And its impact on the allocation of global capital is even bigger than its current-account surplus suggests. This is because it recycles a lot of savings from other countries and redirects those funds towards America. China is a big recipient of foreign investment ($55 billion of net FDI in 2004), and even more speculative capital has flowed in as investors have been betting on a rise in China's currency, the yuan.

Rather than allow these capital inflows to strengthen the currency, China's central bank has chosen to pile up foreign-currency reserves, many of which are invested in American Treasury bonds. Thanks to its own saving surplus and its recycling of savings, China had $711 billion-worth of reserves at mid-year.

On July 21st, the central bank announced that the yuan would no longer be pegged to the dollar but managed against a basket of currencies instead. After an initial 2% rise against the dollar, the yuan has barely moved, but the change is potentially important all the same. China's new currency regime could affect both its saving surplus in general and its appetite for American assets in particular.

China's capacity for thrift has long perplexed economists. A 2000 study by Aart Kraay, an economist at the World Bank, found that between 1978 and 1995 China's national saving rate was, on average, more than ten percentage points of GDP higher than the country's economic characteristics would suggest. It has since risen further. What is going on?

Thrifty habits

Household saving is the easiest to make sense of. First, Chinese households have not changed their consumption patterns fast enough to keep up with the huge rise in their incomes. The boost to saving from higher incomes has been further strengthened by a rise in income inequality: a large part of China's growing income has been going to the relatively small share of the population living in coastal areas. Richer people save more than poorer ones.

Demography, too, has played a big role, as the share of workers in the population has risen. Moreover, the one-child policy has made it harder for people to rely on their children as a source of support in old age, further encouraging thrift. Franco Modigliani and Shi Larry Cao argue in a study published in 2004 (posthumously, in Mr Modigliani's case) that these factors together explain virtually all of the rise in Chinese household saving between the mid-1970s and the 1990s.

A further incentive to saving is the weakness of social safety nets. Under the old economic regime many Chinese workers could count on health and pension benefits from state enterprises (the “iron rice bowl”). No longer. The state sector has shrunk dramatically as a share of the economy, and even those workers still employed by state-owned firms have seen their benefits dwindle.

Pension coverage is low: only about 120m people pay into formal pension schemes, fewer than half the estimated 265m urban workers. Worse, pensions are organised largely at the municipal level, and are not easily portable. A migrant worker in Shanghai who plans to retire to his home village cannot assume that he will get his pension there. In rural areas, pensions are almost non-existent.

Health care is also getting more expensive. China's government spends little on public health services and has been shifting costs on to consumers. Enter the lobby of a Chinese hospital, and you might think you are in a bank. A huge electronic noticeboard flashes up the price of treatments—200 yuan for a cardiogram, 101 yuan for an abortion in one Beijing hospital. A row of tellers lines the wall. You pay cash up front. A serious operation can easily cost a year's salary. With state firms reducing their health coverage and private insurance in its infancy, that is another reason for saving.

Education, too, requires deep pockets, even with fewer children. Again, the state spends little on this, around 2.3% of GDP, much less than in Thailand, Malaysia or India. In a recent survey of people's reasons for saving, education came top.

The relative lack of credit is another factor. Although the mortgage market is growing rapidly, thanks to the government's policy of selling off state housing, consumer credit is still in its infancy. Its growth is hampered by the lack of credit-rating agencies and by the ropy banking system. Like the Japanese in the 1960s, the Chinese need to save a lot because they find it hard to borrow.

And save a lot they do. Chinese household saving, at around 25% of disposable income, is astonishingly high by international standards. But although households account for a large part of China's exalted national saving rate, they were not responsible for the sharp rise in national thrift since 2000. After falling steeply in the late 1990s, China's household saving rate has been more or less steady since 2000 (see chart 9). The recent rise in national saving was led by the government and the corporate sector. Louis Kuijs of the World Bank has examined sectoral saving patterns in China and points out that both these sectors are far more frugal than many observers realise.

The fiscal accounts show the government's revenue to be about 20% of GDP and expenditure slightly higher, resulting in a deficit of about 2% of GDP. But Mr Kuijs argues that these numbers mask a lot of government saving and investing. The government spends only about 13% of GDP on goods, services and wages. The remainder—almost 10% of GDP—is, in effect, government saving, which is then invested, largely through direct capital transfers for infrastructure projects or to support state firms.

Chinese firms, both state-owned and private, are also big savers. Corporate profits soared after 2000, thanks to rapid growth, low interest rates, rising productivity and cuts in employee benefits. Both private and state-owned firms are flush with cash, so their saving has risen sharply. China's firms are now bigger savers than its households.

But unlike their peers in the rest of the world, they are investing their surpluses. With no need to pay dividends (state firms do not have to make any transfers to central government) and little shareholder pressure to ensure that their investment is cost-effective, Chinese firms went on a capital-spending binge, concentrated in industries such as aluminium, steel, car production and cement.

That splurge may well prove unsustainable. Profit growth has slowed sharply over the past year because of excess capacity in the most over-invested sectors, such as cement and steel. Grace Ng of J.P. Morgan, a bank, points out that whereas in early 2004 overall profits in industrial firms were expanding at the rate of 40% a year, by May 2005 the growth rate had slowed to 16%.

Slower profit growth means less corporate saving, but investment seems to be slowing even faster, at least in the most over-invested sectors. The rate of growth of China's imports of capital goods, for instance, is now less than a third of what it was in 2004. But Chinese firms are still selling the fruit of past investment on world markets. As a result, the country's external surpluses are rising. According to Arthur Kroeber, editor of the *China Economic Quarterly*, the investment slowdown will result in “at least a couple of years of blockbuster trade surpluses”.

How far a cyclical slowdown in investment translates into a rise in China's national saving surplus also depends on how consumers react. If firms create fewer jobs, or even lay people off, consumption could catch a cold—which would mean more saving and even bigger external surpluses. Nicholas Lardy, of the Institute for International Economics in Washington, DC, points out that the last time China had an investment bust, in the mid-1990s, consumption slowed sharply and the current account shifted from a deficit of around 2% of GDP in 1993 to a surplus of around 4% in 1997.

So far, consumption growth has barely been affected this time. Retail sales, for instance, show no sign of flagging. But China's current account was already in surplus when the investment slowdown started, and is rising faster than it did a decade ago, so if and when the effects feed through to consumption, the change in the current account could be much bigger than last time. A saving surplus of 10% of GDP, or even more, is not unthinkable.

Whatever the scale of the current cyclical investment slowdown, the pace of China's investment is likely to fall over the medium term. At an aggregate level, China's investment rates seem inefficiently high. Japan and South Korea, for instance, achieved similar rates of growth in the 1960s and 1980s, respectively, with investment levels that were ten percentage points lower than China's. Although investment efficiency has been improving, particularly in the growing private sector, many state firms—which account for much of the over-investment—still earn negative returns on capital. That will change as market reforms continue. Once Chinese banks, for instance, face foreign competition in 2007, they will care more about whom they lend to. Shareholders will become more active and demand higher returns on capital. The introduction of dividend policies would shift more corporate profit to households.

Will consumers wake up?

Better corporate governance will also reduce corporate saving. What happens to China's national saving surplus will depend on whether China's households will save less and spend more, thus becoming the engine of the domestic economy.

The example of Japan is sobering. Although Japanese households now save much less than they used to, their country never really made the shift from export-led to consumer-led growth. It has been running current-account surpluses for four decades. China, however, is different in important ways. Its economy is already much more open than Japan's ever was. Exports and imports add up to the equivalent of 70% of China's GDP, compared with only 20% in Japan. And if July's exchange-rate adjustment turns out to be the beginning of a gradual appreciation, China seems to be shifting away from an undervalued currency far more quickly than Japan did.

Over time, a stronger currency will encourage a reorientation of China's economy towards the domestic consumer, but this is likely to take several years. Although American policymakers may be clamouring for a rapid rise in the yuan, there is no sign in Beijing that the government plans anything of the sort. China's leaders are concerned about unemployment in urban areas as the export sector is squeezed by a stronger yuan, and they worry about unrest in rural areas as farmers have to compete with cheaper imported grain.

A government that depends on rapid economic growth to legitimise itself will not want to risk instability with a sudden rise in the currency, so a much stronger yuan seems an unlikely route to a quick reduction in China's saving surpluses. Reforms to encourage consumer credit and reduce uncertainty about pensions and health-care costs are a better bet. Some such reforms are already under way. China's central bank, for instance, intends to set up credit bureaus in seven provinces this year to help boost the development of consumer finance, and pilot schemes to improve the pension system are in progress in several provinces. Top Communist Party leaders talk a lot about shifting the emphasis of government spending from investment to social safety nets, and recently they promised free nine-year education for children in rural areas. But the government's overall fiscal position has actually tightened this year.

Redirecting an economy as big as China's towards domestic consumption takes time. China's saving surpluses will not last forever, but nor will they disappear overnight. And trying to move too fast can be disastrous, as the mess in Asia's other emerging markets shows.