The Myth of Chinese Savings

by Jonathan Anderson

IF THERE'S ONE thing that absolutely everybody in the global community seems to know, it's that China's economy has been seriously imbalanced for the past five years—and that fixing the problem means fixing the Chinese consumer. Mainland households are no longer counted among the world's poorest but they still generate annual income of less than $4,000 per head, less than one-tenth of what their counterparts in the United States enjoy. The incongruous vision of low-income Chinese families scrimping and saving in order to subsidize the insatiable American consumer has become so firmly engrained in the collective consciousness that it is no longer taken as a point of debate, but rather as a fundamental truth.

As a result, much of the "A-list" of the global economics and policy industry, from the U.S. Treasury to the IMF, the OECD, McKinsey, Goldman Sachs and any number of venerable think tanks, has been generating long lists of recommendations aimed at beating down China's excessive household savings. These mostly involve improvements in the domestic social safety net, consumer finance and agricultural reforms. Global financial investors also have been busily positioning themselves for an inevitable take-off in Chinese consumption, cheered on by broker reports of latent potential waiting to be unleashed as the mainland "turns the corner" from a savings-oriented to a consumer-driven economy.

Amid all the hype, however, it's easy to lose sight of one simple point: The lion's share of China's extraordinary savings explosion since 2003 didn't really come from *Chinese* savings at all. If anything, it would be more accurate to say that China "stole" these savings from the rest of the world, and the true rebalancing of the mainland economy will come as China gives those savings back. As we will see, this has rather different implications for the path of economic growth and related policy prescriptions going forward.

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When the Weirdness Began

CHINA HAS ALWAYS had a dynamic economy at home, but until recently it was a mild-mannered and yawningly predictable player abroad. Between 1982 and 2002, the mainland surplus on the current account (the net balance of merchandise goods and services trade vis-à-vis the rest of the world) fluctuated around a level of 1% to 1.5% of GDP per year. In other words, China was running surpluses—but barely so, and certainly not to an extent that would capture the attention of the global community.

And then, beginning in 2003, something changed. China's external surplus jumped to 2.8% of GDP and then to 3.6% in the following year; by 2005 it had reached 7.2%, and at the peak in 2007 the surplus was an eye-popping 11% of GDP, a virtually unprecedented level for an economy of China's size. The earnings generated from these surpluses sent China's official foreign-exchange reserve assets soaring to more than $2.5 trillion (including funds transferred to the recently created sovereign wealth fund) as of this writing from a humble $150 billion at the beginning of the decade.

Where did the money go? Some two-thirds of it was channeled directly into the U.S. economy, and particularly into Treasury and quasi-official bonds—making China the single largest foreign creditor to the U.S. government. This, in turn, allowed American households to borrow and spend unflaggingly for a full half-decade without having to worry about the impact of sharply rising external deficits on dollar interest rates. If you will, China effectively financed the U.S. consumption and housing boom and eventually the subprime finance bubble.

And where did the money come from? The current-account balance is equal by definition to gross domestic savings less gross domestic investment. So if households and firms are spending more than the available pool of savings, the economy will run necessarily run a trade deficit; if savings are higher than local demand for investment, the economy will run a surplus.

If we look at other cases in postwar history where emerging countries suddenly recorded a large spike in the external balance, the culprit was almost always investment, roughly in line with the following scenario. You had a crisis, long investment demand plummeted, import spending fell alongside and the trade surplus rose sharply as a result. This is a "normal" part of the emerging business cycle—and this story has played itself out again over the past 12 months in countries such as Turkey, Vietnam, Ukraine and the Baltic states.

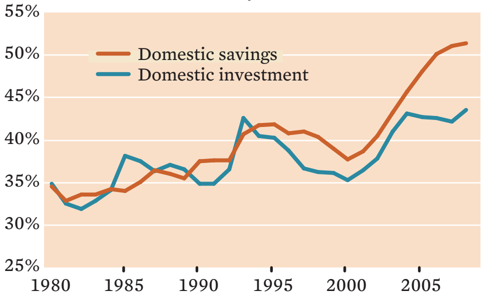
China's case, however, is anything but normal. As it turns out, the rising surplus had nothing to do with falling investment; in fact, investment demand *rose* significantly over the last five years. Instead, the culprit has been savings. Just look at the picture in the chart below; China has always had one of the world's highest domestic saving rates, averaging around 40% of GDP over the course of the 1990s—and since 2003 that rate has exploded upward to reach nearly 52%, a level that very few countries in the world have ever even come close to.

The mathematical counterpart to this is a consumption ratio that fell off the other way. Total consumption was about 60% of the Chinese economy during the previous decade, but as of last year the figure had fallen to 49%; for household consumption the numbers were 46% and 35%, respectively. Again, these are extraordinarily low numbers by international standards, making China a very imbalanced economy indeed.

And this is where the trouble starts. For most observers looking at these ratios—including many of the best profes-

THE GREAT SAVINGS LEAP

Share of GDP



SOURCE: UBS

sional economists—the underlying explanation is simplicity itself: For whatever reason, over the past five years Chinese consumers "dropped the ball" and began spending less and less, and saving more and more. To some the driving force was a severely undervalued exchange rate that eroded overseas purchasing power, for others it was an erosion of social safety protections and rising uncertainty about the future. But in any case the result was both a drop in import spending and a flood of new household savings that flowed into overseas assets.

False Start

IF THIS IS the case, then the only way to solve the problem is to get China's consumers spending again. Currently favored policy prescriptions include the introduction of rural pension insurance, an overhaul of the aging health-care system, greater support for public education, better consumer finance incentives and agricultural land tenure reforms. Indeed, the mantra of "making China a consumption economy" is repeated whenever and wherever global imbalances are discussed.

Now, those living in China's cities can be forgiven for scratching their heads just a little bit at the above arguments. Living standards are still rudimentary by developed benchmarks, to be sure, but nearly every available consumption indicator, from sales to surveys, showed frenetic growth over that same five-year period, with a rapid increase in spending on travel, restaurants and consumer goods.

Nor was the rural economy stagnating; in fact, this was the first time in more than a decade that farmers finally saw a "double punch" of rising food prices from agricultural activity and higher wages for rural migrants in the low-end factory and construction sectors, both of which significantly boosted incomes and spending. And all of these trends pale when we turn to the biggest story of all—the absolute explosion of household expenditure on housing and automobiles, with sales growing an astounding 35% annually from 2002-07. Simply put, none of the above smacks remotely of consumers dropping the ball.

As for China's social and financial state, it is simply impossible to find another economy with per capita incomes under $5,000 that can rival the mainland in the coverage of its urban pension system (much less any rural coverage at all), the availability of clinics and hospitals, the sheer size of the banking system as well as the availability of credit cards and mortgages, the relative number of publicly funded schools and universities, the equality of rural land distribution or the level of per-hectare agricultural yields. Of course none of these indicators can compare with those in advanced economies. But if the "social safety net" is the key factor behind China's savings, then why don't we see even higher domestic saving rates in Algeria, Bolivia, Cameroon, Egypt, Indonesia, Kenya, Mongolia, Philippines, Thailand or the remaining many dozens of nations with social indicators that fall considerably short of those in China?

And even if we *were* to accept that China's welfare system was particularly to blame, then why 2003-07? After all, rural peasants have never had pensions; the biggest wave of urban unemployment had already come and gone more than a decade earlier, as did the initial drop in public-health and education spending. By contrast, this decade has seen a resurgence of government spending across all categories, the first major reworking of the urban pension system and the biggest upsurge in consumer leverage the country has ever seen.

True Source of Savings

BEFORE GOING ON, it must be admitted that Chinese households *do* save quite a lot, anywhere from 16% to 18% of GDP, which is a very high number by either developed or emerging standards. But here's the crucial catch: When we look at the veritable explosion of *increased* savings coming out of China over the past five years, virtually none of it came from the household sector. Rather, according to the best available estimates based on flow of funds data, the real story is the sudden rise of gross *corporate* savings, which shot up to more than 26% of GDP by 2007 from about 15% of GDP at the beginning of the decade.

In national accounts parlance, "gross corporate savings" is nothing more than total corporate earnings, or corporate profits. So over the space of a few years Chinese profits shot up dramatically as a share of the economy and by far more than could be reasonably invested at home.

How did this happen? Did individual Chinese companies suddenly become more profitable? Surprisingly the answer is no, not at all; unit margins haven't really increased over the last decade. And this leads to the very paradoxical (but absolutely verifiable) picture in the nearby chart. The green bars show the path of industrial margins in China, and as you can see gross profits as a share of total revenues have been very stable; meanwhile, the blue line shows the path of those very same gross profits as a share of GDP ... and this ratio has increased very sharply since 2002.

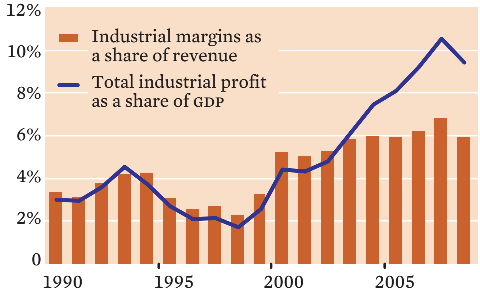
How could aggregate profits go up if individual profit margins did not? The answer is a truly stunning expansion of industrial sales revenue relative to GDP, more than doubling over the past seven years. Equally surprising is that there was no sharp increase in sales coming from traditional export goods such as toys, textiles or information-technology electronics, i.e., the stuff that goes to feed the voracious U.S. consumer. Rather, the action came from heavy industry, and specifically areas such as steel, aluminum, cement and other basic materials, autos and auto parts, machine tools and specialty chemicals—i.e., mostly sectors that support the domestic housing and auto boom.

If this is all a bit confusing, then it might help just to think about the steel sector, which was one of the biggest single contributors to the heavy industrial boom. If China used to produce and sell $1 worth of steel per unit of GDP in 2002, by 2007 it was producing and selling three, an astonishing increase in capacity over such a short period of time.

Where did all that steel capacity go? The short answer is that roughly half of the supply increase was actually "needed" at home, to satisfy China's rising domestic demand for housing and property construction as well as fixed-asset investment. The other half was surplus capacity—and ended up being "exported" abroad into global market.

I say "exported" because China began in 2002 as a sizeable net importer of steel and steel products, so the first thing that domestic producers did was to take over market share at home from foreign suppliers. It wasn't until 2005 that Chinese steel companies actually began exporting outright in large quantities. But in terms of the impact on the trade surplus, it didn't really matter; it was precisely the full swing from a net import to a net export

VOLUME DRIVES PROFIT



SOURCE: UBS

position in steel, other metals, and basic material and machinery that accounted for the bulk of the rising trade surplus. It was this historically unprecedented "market-share grab" that allowed the economy to record a much bigger expansion in heavy industrial sales and earnings than it otherwise could have, pushing up both the domestic savings ratio and the trade balance dramatically in the process.

In other words, no one put off consumption in Chinese homes, and U.S. households were not exactly borrowing from poor peasants toiling in the fields and factories to make the cheap consumption goods they demanded. In fact, in some sense these are not really *Chinese* savings at all. Of course the excess income accrued to mainland companies, but that income was earned by taking industrial market share away from foreign producers.

Why did Chinese companies and their local-government sponsors invest so heavily in production of steel and other heavy industry capacity, even as the central government was trying to apply the brakes on such projects? There is clearly an element of bandwagoning and irrational exuberance in this story, one that has repeated itself throughout mainland boom-bust cycles in the 1980s and 1990s. But remember that in the early 2000s producers in such industries were reaping massive profits, and demand was growing quickly. As with most bubbles, it started with a response to market fundamentals and then radically overshot.

China and … Saudi Arabia?

THIS THESIS MAY sound more than a little exotic by the standards of most global economies, but there is a group of countries that regularly show almost the same macroeconomic trends as China. Think about an economy like Saudi Arabia when it first strikes oil. What happens to the national accounts? First, the sudden increase in exportable fuel production is shipped abroad, leading to a massive increase in the trade surplus. Second, the counterpart to that rising trade surplus is an equally large increase in domestic savings, as export earnings pile up in the government and oil companies' coffers. And third, the domestic consumption share of GDP falls precipitously, as only a small share of those export earnings actually make it to the pocketbooks of Saudi households.

So we see a sharply rising savings/GDP ratio and a sharply falling consumption/GDP ratio, but does it automatically follow that Saudi consumers suddenly dropped the ball and began saving more—and that the economy can be rebalanced by unlocking hidden reserves of household savings? Not in the least. Again, those savings didn't come from *inside* the Saudi economy at all; they came from selling oil abroad. And the Saudi consumption ratio fell not because consumers were spending any less, but rather because the size of the overall economy suddenly expanded around them.

And so it is in China—with the sole difference that instead of oil, the Chinese "struck" steel and basic materials. The impact on the mainland national accounts is precisely the same: Rising heavy industrial capacity leads to a rapid expansion in net exports, GDP growth and gross savings. Meanwhile, Chinese consumer incomes and spending continue to increase at the "same old" pace of 8% to 9% in real terms, i.e., nothing has changed for mainland households and China is still one of the fastest-growing consumer economies in the world. But with excess supply growth pushing overall GDP into the 11% growth range, you get a sudden trend decline in the household consumption *ratio*.

Real Rebalancing

SIMPLY PUT, THERE'S nothing disastrously wrong with Chinese demand—it's heavy industrial *supply* growth that was far too strong. This has very different implications for eventual policy solutions. In such an environment the most likely and effective rebalancing does not come from spending more at home; China expropriated those savings from abroad in the form of market share gains, and a "true" rebalancing means giving those savings back.

What kind of policy measures can work? The following three top our list, in increasing order of likelihood and importance.

✹ *Extract savings from companies and give them to households*. One of the reasons that the Gulf countries, Russia, Kazakhstan and other major oil and fuel exporters can sustain ultra-high saving rates over a protracted period of time is that export earnings accrue to a very concentrated group of entities, usually a few oil majors and the government. Average citizens and households do receive public spending benefits and sometimes mild dividends, but they are not the residual claimant on the exporting assets and as a result have no feasible way of "spending" the surpluses.

Very much the same is true in China. The massive surge in heavy industrial supply and exports did not lead to much of an income boost (if at all) for average consumers; these are mostly state-owned or local government-led companies, and even the word "state-owned" is not really correct in the case of China since there is very often no residual claimant on earnings at all. The state normally doesn't receive dividends, minority shareholders are usually small and fragmented, and in this environment large companies often have nothing to do with profits but reinvest them or simply accumulate assets.

As a result, there is a compelling mandate for corporate ownership reforms that would provide for a more direct and immediate transfer of profits to major shareholders, including the government as well as households. However, just as in the case of the oil majors mentioned above, a compelling argument in theory can take decades to be implemented in practice; Chinese policy makers have been talking about dividend reforms for a very long time already, and we would be shocked to see any significant change in actual flows within the next 10 years.

✹ *Stop building steel mills, and maybe even close some down*. Next up is the most logical consistent measure of all—and as of 12 months ago the one that seemed most likely as well. If the source of the problem was a wave of excess capacity creation in key metals and materials sectors, then why not just stop building that capacity and perhaps even shut some of it down? This would be a nice, neat way to reverse the course of rising surpluses and give some of those "stolen" savings back, as rising Chinese domestic demand gradually ate through the capacity overhang and eventually brought the economy back to a more natural net import position once again.

For a while in 2007 and 2008 it looked as if this was the way China was going, as low capacity utilization rates in sectors such as steel and autos, together with the weakening global economy, led to a visible slowdown in new investment activity. However, this year two things have happened to derail this process. First, in its panic over the potential effects of the global crisis, the government successfully engineered a stunning pickup in private housing construction and state infrastructure spending, both of which have caused an explosion of new local demand for industrial materials. Of course the external trade balance has fallen sharply as productive capacity was quickly diverted to the domestic market, but the resulting sudden rise in capacity utilization also makes these sectors more attractive as a new investment destination.

This brings us to the second and more important concern, which is that any semblance of new lending discipline seems to have been thrown to the wind as banks were encouraged to lend to anyone and everyone who walked through their doors. A big stimulus "burst" that boosted domestic demand in the near term and helped take up slack capacity would not be such a bad thing, even if it were a very temporary phenomenon, as long as it didn't result in another wave of productive capacity creation. But the worst of all possible worlds would have to be a short-lived demand stimulus program that resulted in yet another massive, long-term capacity overhang. And the crazed money- and credit-growth numbers of the past 12 months give plenty of reason to worry that this might be where we're headed.

✹ *Move the exchange rate.* It's far too early to be sure, of course, and we could be pleasantly surprised at how moderate Chinese companies are in their new expansion plans. However, if we do wake up with yet another round of credit-fueled heavy industrial growth and a renewed jump in the external balance back to 2007 highs, this really leaves China with only one possible policy response—to let the renminbi strengthen, and by considerably more than we have seen to date.

There has never been much logic in the arguments of the "Bretton Woods II" camp, who claim that it was precisely a structurally undervalued exchange rate that caused the growth of industrial capacity in the first place, and that exchange-rate factors also artificially suppressed domestic consumption demand as well. Nonetheless, they may be absolutely right that a much more significant exchange-rate adjustment is the only lasting solution to China's current imbalances.

This is a very different view from the "savings fundamentalists" such as Nobel Prize-winner Robert Mundell, who has consistently argued that moving the currency can do nothing to change China's savings rate and thus would have no impact on the external current account. If China's surpluses came from millions of households putting off purchases and storing away pennies for a rainy day, we would have some sympathy for this view. But since the real story behind rising national savings is essentially a market-share grab, as a flood of new domestic producers steal earnings away from foreign counterparts, letting the renminbi appreciate turns out to be a very efficient way of reducing the savings rate—and giving those savings back.

How does it work? Very simple: By reducing the local-currency equivalent from a dollar's worth of exports, a stronger renminbi immediately makes Chinese heavy industrial producers less competitive vis-à-vis overseas competitors, and this lowers the aggregate amount of corporate savings through two channels: lower domestic margins on every unit of foreign sales, and lower sales volumes at home and abroad, as foreign producers claw back market share. And this, needless to say, has the effect of reducing the external trade surplus as well.

In short, rather than obsessing about the state of China's pensions and health care, steel capacity and the renminbi exchange rate are the two crucial indicators to watch.