



Sinology

by Andy Rothman

July 7, 2014

- * Consumption may be a small share of GDP, but by any other measure China's consumer spending is very strong, with real retail sales up 10% year-over-year.
- * Income has more than doubled over the last decade, and in recent years private consumption has been growing by 9% in China, compared to less than 2% in the U.S., Japan and Germany.
- * 'Rebalancing' of the Chinese economy is already well underway, and there is no reason for investors to wait for that process to finish. China is already a fantastic consumption story.

.....

ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

WORLD'S BEST CONSUMPTION STORY

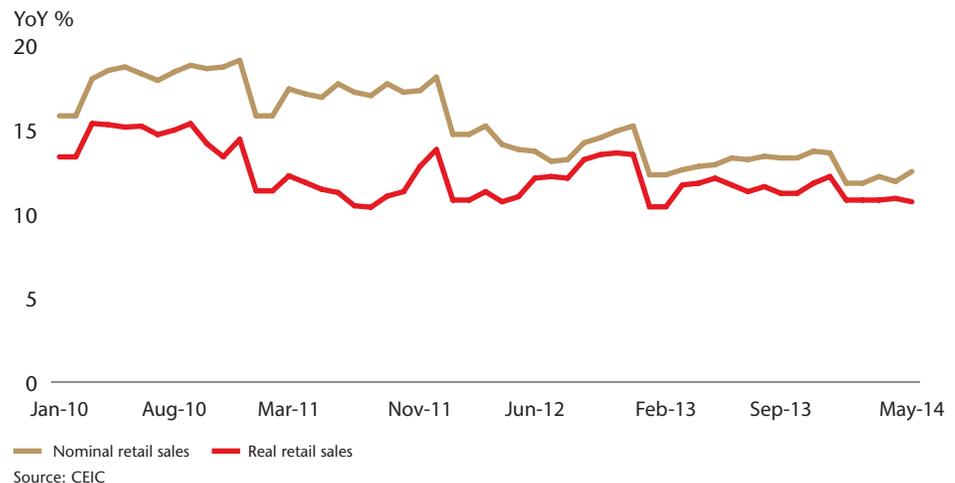
Household consumption is a small share of GDP, but Chinese are strong consumers.

Household consumption accounts for a small share of China's GDP: 36% in 2013, down from 46% in 2000. This is quite low when compared to the U.S., where household spending is 68% of GDP, or the U.K., where the share is 64%. The Organization for Economic Co-Operation and Development (OECD) average is 55%, and in India, household consumption is 57% of GDP.

These statistics have led a parade of world leaders and famous economists to argue that consumption in China is weak, and that the Chinese government must take urgent steps to 'rebalance' its economy. In this issue of Sinology, however, we will explain why China is already the world's best consumption story.

Consumption is already strong...

By most metrics, private consumption in China is already exceptionally strong. In the first five months of 2014, real (inflation-adjusted) retail sales rose 10.8% year-over-year (YoY), after rising 11.5% last year. During the period from 2005 to 2010, real retail sales increased at an average annual rate of 15%.



Strong consumer spending is also evident when we look at specific categories of goods. Sales of laptops, for example, rose 7.1% YoY last year (by value). That was down from a 24.5% growth rate in 2007, as almost every aspect of the Chinese economy is growing more slowly, in part because the base has grown so large. But Chinese bought 24.4 million laptops last year, more than double the 10 million sold at the faster growth rate six years earlier. By comparison, 17 million laptops were sold last year in the U.S., and sales by value fell 11.8% YoY.

Apparel sales rose 8.2% YoY last year in China, to 36.6 billion units. In contrast, apparel sales in the U.S. rose 2.2% last year to 17.1 billion units.

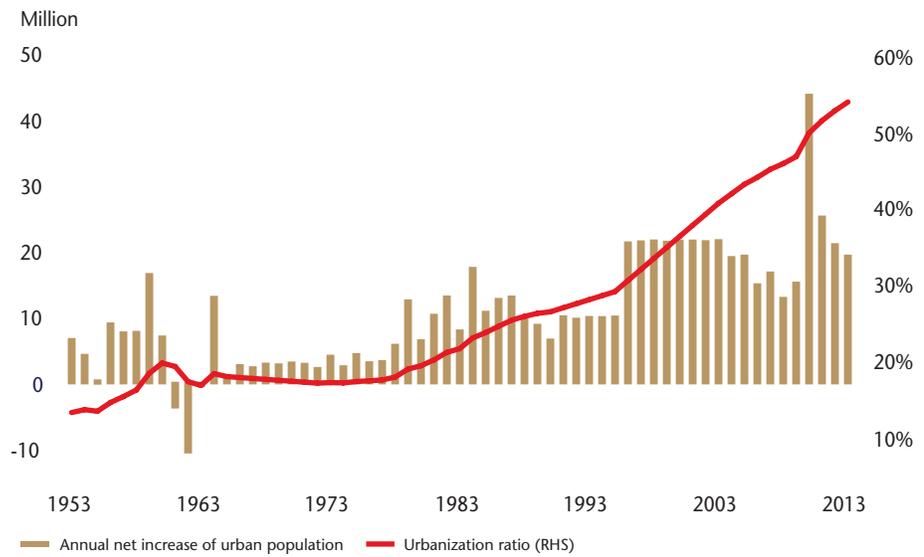


Chinese consumers bought 64.2 million air conditioners last year, up in value by 11% YoY, while air conditioner sales in the U.S. rose 7.7% to 7.8 million units.

Moreover, as we explained in a recent Matthews white paper on China ('Separating Fact from Fiction'), if we add household spending on real estate to other purchases—effectively treating it as consumption—private consumption is a significantly higher share of GDP and has remained fairly steady over recent decades.

...supported by strong income growth

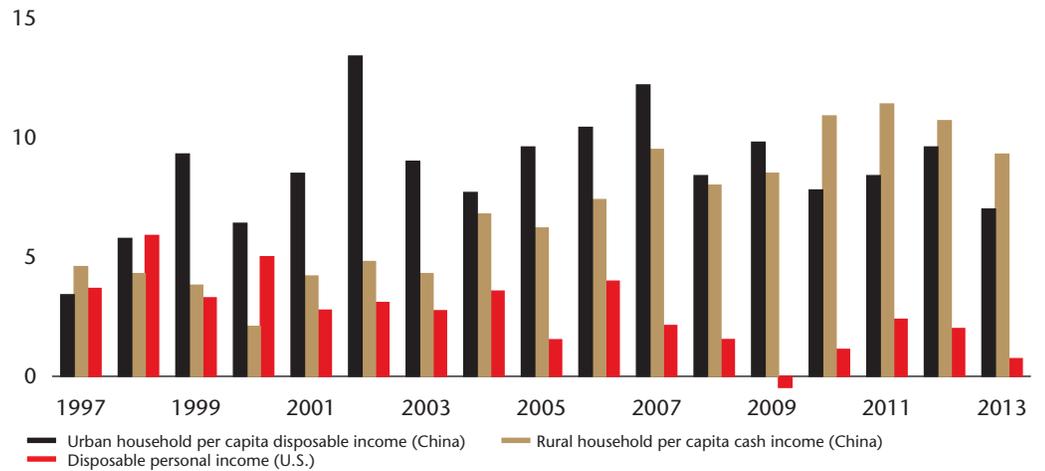
This strong growth in consumer spending is driven by several factors: healthy consumer confidence; low household debt; rapid income growth; moderate inflation; and growing demand for goods and services from the large number of Chinese who have only recently earned enough money to move into the consuming class—in part through the urbanization process, which allows millions of people to make the transition from subsistence farming to salaried jobs. The proportion of Chinese living in urban areas has risen from 11% in 1949 to 53.7% in 2013, and we expect another 15 million people to make the migration annually for the next few years.



Source: CEIC

Unprecedented income growth is the most important factor supporting consumption. Over the past decade, real urban income rose 139%, while real rural income rose 134%. Some of that increase was driven by government policy: the minimum wage in Shanghai, for example, rose 187% over the past 10 years. (In the U.S., real disposable personal income rose 18.3% over the last 10 years.)

Real Growth Rate, YoY %

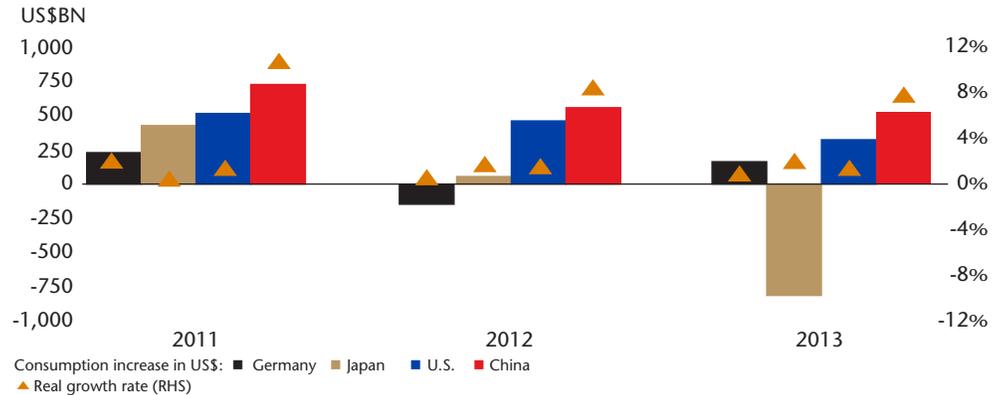


Sources: National Bureau of Statistics, China; U.S. Department of Commerce



Chinese consumption growth outpaces that of the U.S.

Private consumption is growing more rapidly in China than in other countries. Over the past three years, real growth in consumption averaged 9.1% per year, compared to 1.5% in the U.S. and Japan, and 1.2% in Germany, according to IMF calculations.



And if we convert China’s private consumption into US dollars, the growth in consumption last year was equal to US\$528 billion, compared to an increase of US\$323 billion in the U.S.

So what’s the problem with consumption?

Analysts who worry about consumption in China do not pay much attention to the data we have just described. They focus instead on the low share of household consumption in GDP, and worry if the economy can be “rebalanced” towards consumption. But they misinterpret the data.

The reason that household consumption is a small share of China’s GDP is not because consumption is weak. On the contrary, as we have just outlined, Chinese consumers have experienced dramatic income growth and have been spending freely. Private consumption is a small share of GDP because the Communist Party has over the past decade dramatically ramped up its spending on public infrastructure. Infrastructure has accounted for about one-third of overall investment, which has grown even faster than consumption and has been the lead driver of GDP growth.

By building out in one decade the modern infrastructure that the U.S. took a century to create, the Party pushed GDP growth up into double digits, with most of that growth coming from investment, squeezing out the share of GDP (or GDP growth) that could come from private consumption.

In other words, the “problem” was not due to weak household consumption: it was because fixed-asset investment (FAI) boomed as the Party built basic infrastructure, manufacturers modernized and construction of privately-owned urban housing was permitted for the first time. FAI rose at an average annual pace of 25.8% from 2003-11, compared to a 12.5% rate from 1995-02.

What about rebalancing?

For those who are waiting for the “rebalancing” process to begin, that day has arrived. China’s transition away from investment-led growth is already underway: after rising at a roughly 25% YoY pace for nine years through 2011, FAI growth has been slowing, and this year is likely to increase by about 16-18%. This slower YoY FAI growth is inevitable, as so much as already been built and the base has become so large, and it means that GDP growth will also continue to decelerate, from 10.4% in 2010 to 7.7% in 2012 and 2013, to our forecast of 7-7.5% this year and 5-6% in 2020.

With GDP growth and FAI both slowing while consumption remains robust, the investment share of GDP will begin to decline and the consumption share will rise. But for investors, there is no reason to wait for that process to play out. China is already a fantastic consumption story.

Andy Rothman
Investment Strategist
Matthews Asia

The views and information discussed in this report are as of the date of publication, are subject to change and may not reflect the writer’s current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general.

The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation. Matthews International Capital Management, LLC does not accept any liability for losses either direct or consequential caused by the use of this information.