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Household consumption, domestic demand, and challenges to China's grand economic rebalancing

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Abbreviations

CHFS	China Household Finance Survey
CME	Coordinated Market Economies
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IMF	International Monetary Fund
LCH	Life Cycle Hypothesis
LME	Liberal Market Economies
NGM	National Growth Models
RMB	Renminbi (Chinese Yuan)
SOE	State-Owned Enterprises
UK	United Kingdom
US	United States
VOC	Varieties of Capitalism

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Introduction

In recent years, China has emphasised the critical importance of a domestic demand expansion strategy, centred on consumption as a key policy driver, to promote future economic development. This strategy, called the 'dual-circulation' strategy, was proposed by President Xi Jinping at the Politburo Standing Committee meeting in May 2020. Touted as the vision for a new development model, it would mark a systemic shift of the economy away from the reliance on investment and exports (external circulation) to one that is more supported by domestic demand.[1] The strategy seeks to leverage China's huge market size and unlock the potential of domestic demand, and places particular importance on expanding household consumption.

China's economic growth in the last three decades has been driven by an export-oriented development model that has been popular among other East Asian economies, such as Japan, South Korea and Taiwan. However, what is more pronounced in the Chinese practice has been the sheer macroeconomic imbalances between high investment and low consumption.[2] Therefore, the internal circulation, based on boosting domestic demand and raising private consumption, is expected to rebalance China's macroeconomy toward more sustainable and quality growth. As the second largest economies in the world, China's economic restructure is bound to have profound implications over the global economy as well.

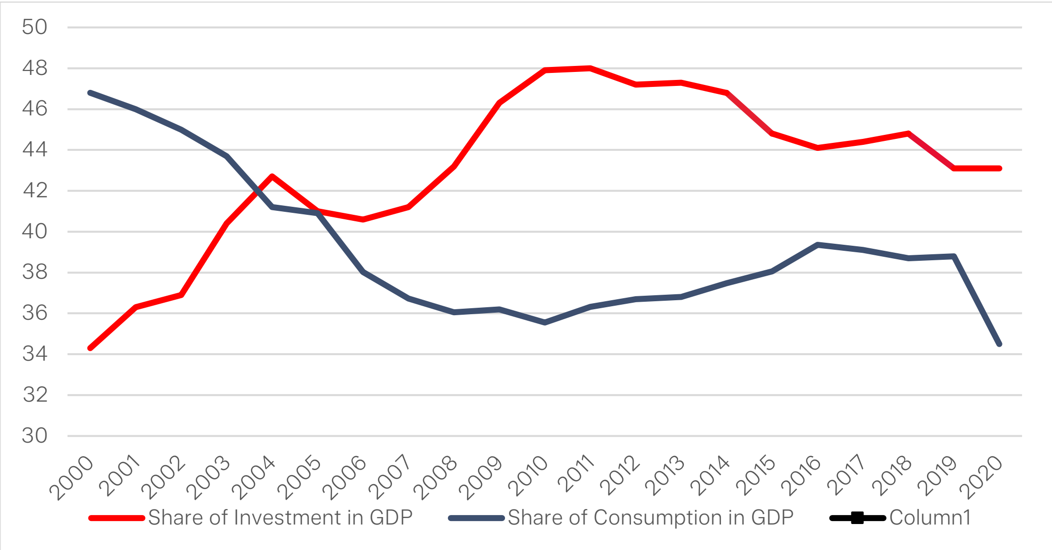
We argue that such a grand rebalancing of the macroeconomic structure faces daunting challenges on the fronts of demand, particularly private consumption. While there have been substantial studies on the issue of insufficient demand in the Chinese economy, this paper represents a pilot effort in combining macro and micro economic approaches under a framework of political economy in examining the cause of consistent low levels of domestic demand and household consumption. Three issues are identified. The first is distorted distribution of national income, in which labour wage and household income are repressed on a systemic level. The second is a seeming contradiction of high savings rate and unsustainable level of household debt, which has been rising rapidly for a decade and further deteriorated amid the COVID-19 pandemic. The third is the demographic challenge associated with China's declining population and aging society. These are all significant issues that will restrain household consumption in the medium to long term and pose significant obstacles to the success of Beijing's demand expansion strategy. For the rest of the paper, we will first embed the discussion within the growth model literature and the importance of aggregate demand. This is followed by more detailed explanation of the income, savings, debt and demographic factors that have helped repress household consumption in China. The paper concludes on the political and economic difficulties in the transition away from the current growth model.

National growth models and China's macroeconomic imbalances

Neoclassical economic theory tends to argue that economic growth is driven by supply-side factors, such as productivity, labour force participation, population growth and technology progress. [3] Nevertheless, the structure or composition of economic growth also reflects the structure of aggregate demand in the economy in terms of the contributions from consumption (public and private), investment, and net exports. In particular, Baccaro and Pontussen,[4] based on a post-Keynesian framework, have pointed to the way in which these different components of aggregate demand can define varying 'national growth models' (NGM) aimed at spurring economic growth and dealing with distributive conflicts. This line of research is further linked to the varieties of capitalism literature that examines the role of growth models in global imbalances.[5] This is linked to the varieties of capitalism (VOC) literature that focuses on the organisation and management of production on the supply-side of the economy. The VOC approach differentiates between Liberal Market Economies (LMEs), such as the US and UK, which tend to rely mainly on markets to coordinate production relationships, and contrasts these with more Coordinated Market Economies (CMEs), as found in Germany, Japan and indeed China. From the perspective of the NGM, the LME economies are built on consumption-led growth models with relatively high consumption-to-GDP ratios. Conversely, CME economies have relied to a greater extent on an export-led growth model, featuring much higher net exports-to-GDP ratios than found in the LME economies.

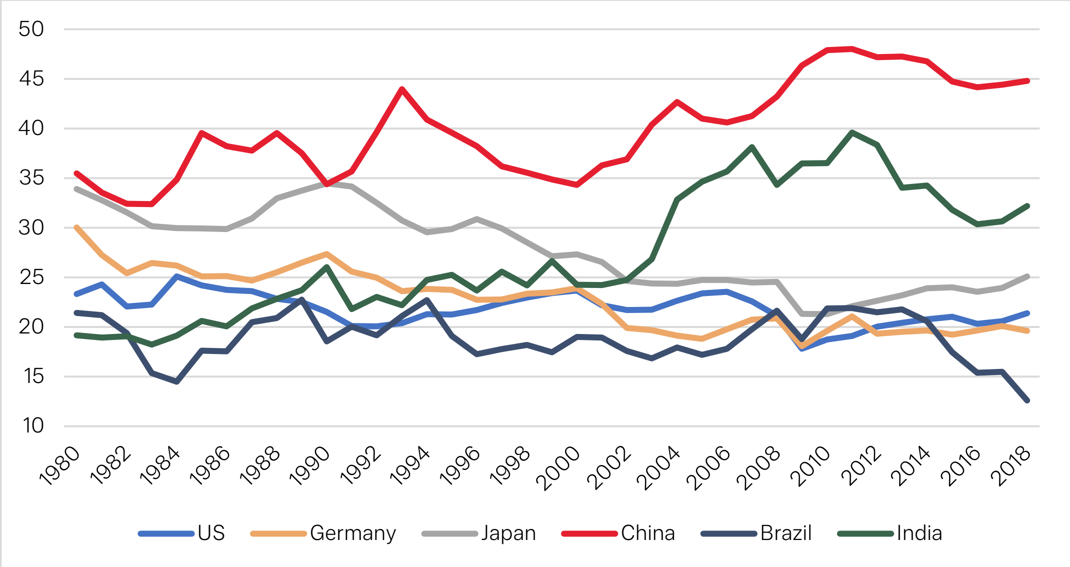
More importantly, the NGM literature highlights the *institutional* settings that underpin national trajectories.[6] Viewed from this perspective, China's growth so far has been decidedly driven by investment (financed by domestic high savings) on the back of low consumption. Despite a decline in the share of investment from its peak in 2010-11, its average between 2008 and 2020 has been over 45 percent, higher than the pre-GFC average of 39 percent between 2000 and 2007 (Figure 1). It is also well above the level found in a range of advanced economies and other major emerging economies (Figure 2).

Figure 1: Share of investment and consumption in China's GDP (%)



Source: IMF World Economic Outlook Database and CEIC.[7]

Figure 2: Total investment as % of GDP from comparative perspective

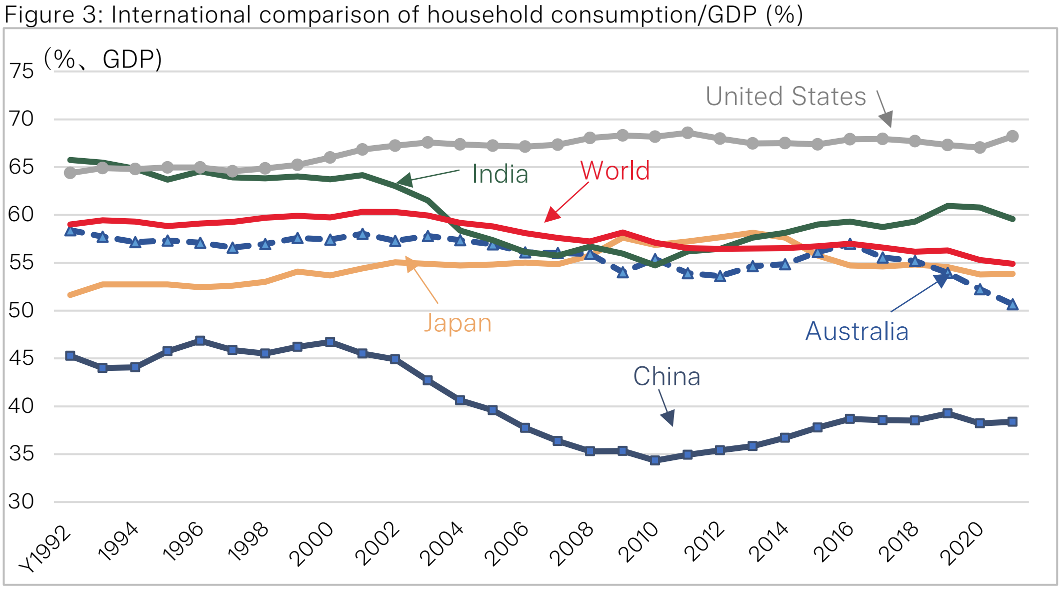


Source: IMF World Economic Outlook and CEIC.[8]

A consistently high national savings rate is at the heart of China's macroeconomic imbalances, standing at 44.6 percent of GDP in 2021.[9] This is well above the global average of 20 per cent for advanced economies and 15 per cent for emerging economies.[10] Savings and credits have been absorbed by elevated investment. While a relatively higher level of investment is needed for developing economies such as China (particularly infrastructural investment), the return on investment has fallen steadily since the early 1990s as industrial infrastructure has been increasingly saturated. The incremental capital-output ratio more than doubled between 2007 and 2018, meaning that more than twice the level of investment was needed in 2018 to generate the same level of output achieved a decade earlier, clear indications of investment inefficiencies and diminishing returns.[11]

From a macroeconomic perspective, household consumption is the largest demand item in most countries, accounting for over half of GDP. Corresponding to high investment in China has been low level of household consumption. As shown in Figure 3 using the World Bank database, the share of consumption in GDP in China has been consistently lower than both advanced economies and emerging economies. It bottomed at around 34 percent in 2010, stagnated since 2016, and remained below 40 percent by 2021 compared with the global average of 55 percent.

Figure 3: International comparison of household consumption/GDP (%)



Source: IMF database.[12]

Therefore, China's current growth model is unsustainable due to imbalances between high investment and low consumption within the aggregate demand, which leads to over-capacity and mounting debt across major sectors of the macroeconomy, with total non-financial debt standing at 277 percent of GDP in 2021.[13] The central task in rebalancing the economy, therefore, would be to increase consumption (especially household/private consumption) and reduce investment. In other words, the growth model needs to be recalibrated to be one that is driven by a higher level of consumption. In addition, repressed domestic consumption also means an over-reliance on external demand. However, as the geopolitical rivalry between US and China intensifies, the access to western markets is at risk, which further highlights the necessity and urgency to boost domestic demand and private consumption.

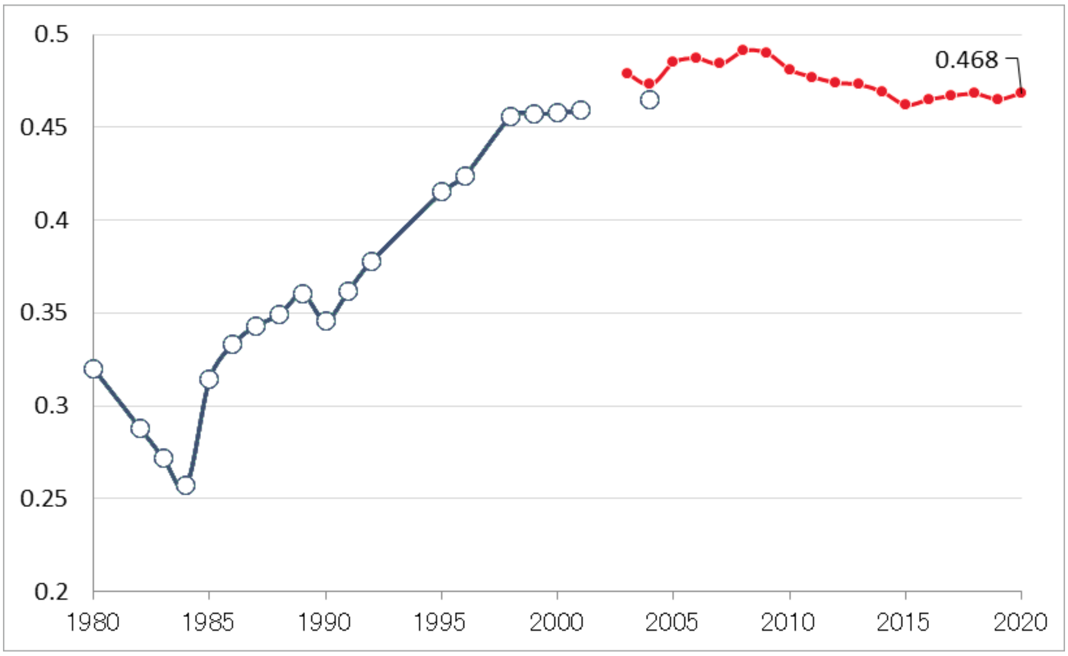
We argue in this paper that consumption repression in China has been profoundly shaped by and embedded in, the current growth model. In particular, three broad categories of structural factors are identified, including income distribution, household savings and borrowing, and trajectories of the Chinese population.

Distortions in national income distribution

Income tends to have direct impact on household consumption as households' propensities to consume and saving behaviour vary with income levels and depend on income distribution.[14] First, labour's share in national income correlates positively to household consumption. According to Tan,[15] labour's share in national income, the proportion of employee compensation to nominal GDP, decreased significantly from 52.8 percent in 1997 to 39.7 percent in 2007. The decline was due to a reduction in the primary income of households and limited net government transfers.[16] Recent research by Liu and Bai[17] finds that, despite labour's share in national income turned to a rising trend since 2008 (reaching 57.6% in 2022), it is still 10 to 15 percentages lower than that in advanced economies.

Although real household incomes in China have experienced constant increase at around 10 percent annually, this growth has been accompanied by a notable rise in income inequality between (and within) urban and rural areas, and coastal and inland regions.[18] Yan points out that China's official figure of Gini coefficient,[19] a key indicator to measure income inequality, peaked in 2008 but was still at a high international level of 0.462 in 2015. The inequality in disposable income among households has risen again since 2015, reaching 0.468 in 2021 (Figure 4).

Figure 4: Gini coefficient of disposable income of Chinese households



Source: Data provided by Professor Shanping Yan, Doshisha University.

Households in poverty tend to have a higher marginal propensity to consume, especially in China where an expansion in income inequality leads to suppression in consumption.[20] For example, Chen[21] has shown that expanding income inequality suppresses household consumption and increases the household savings rate in China. In addition, a study by Jin et al.[22] suggests that, under increased income inequality, urban households are incentivised to save, especially among low-income and young households, as they seek social status.

Apart from rising income gaps, China's growth model and its associated institutions also entail a systemic distortion over household income. First of all, an export-driven economy builds on labour (and wage) repression, such as in Germany.[23] Under such as model, wages are repressed to reduce cost and increase export competitiveness.[24] This is further compounded in China given a lack of genuine organised labour and meaningful collective bargaining despite limited efforts in reform on regional levels.[xxv] In addition, local governments tend to favour capital in industrial disputes amid regional competition to attract investment, which generates further downward pressure on wage growth.[25] Moreover, the state's monopoly in the banking sector and the capital control regime enables government regulation of interest rates. In particular, the government has been able to set deposit rates lower than market equilibrium.[26] This helps provide low-cost funds for the banks, which are then directed to lend to the state sector. The gap between the official and market deposit rates has been one of the key features of financial repression that underpin China's investment-centred growth model. For household savers, this is essentially a deposit tax that reduces their asset income. At the same time, China's export-led growth model operates on an interventionist exchange rate policy, in which the government tends to maintain an undervalued currency to foster export competitiveness, at least in the 1990s and 2000s.[27] However, an undervalued currency reduces the purchasing power of the household, which also dampens private consumption in China.[28]

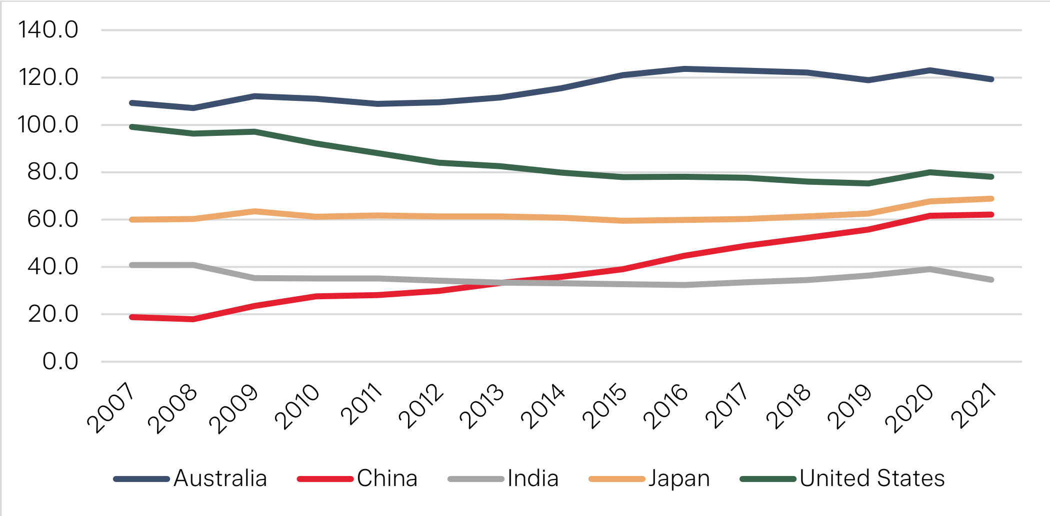
High household savings and debt

The state of Chinese household finance features simultaneously high levels of savings and debt. The coexistence of high savings and high debt within the household sector, on both micro and macro levels, is not uncommon, often reflecting the diverse financial situations and household behaviours. In China's context, this reflects highly uneven wealth distribution and wider income and economic inequalities discussed above. This has been the net result of higher-income families having the capacity to save more and the liquidity to service more debt, whereas a significant portion of households have low or negative savings due to high debt and low income. It also reflects dual household priorities of long-term saving for the future, including retirement, health and education, as well as short-term needs in the form of debt, such as buying a home through a mortgage.

As discussed earlier, household savings correlate directly to household consumption, and high levels of household savings form a key dimension of low household consumption in China. There have been several institutional mechanisms that led to high savings in China. First, Chinese households tend to save with a target level in mind.[29] Repressed and sluggish wage growth, coupled with declining real interest rates and deposit returns have forced households to save a larger proportion of their income to meet their savings target. Second, as discussed above, the rising income inequality has also contributed to the increase in household savings.[30] Third, economic reform has seen the government reduce its social spending, shifting the burden of the pension system and social services from public budget to households, which in turn has increased the pressure for precautionary savings. In particular, reforms since the 1990s have seen the dismantling of the generous welfare system provided by the public sector, and the burgeoning private sector does not offer welfare support to workers. The new social safety net that is meant to replace the old welfare system has been slow in the making, and has been fragmented, inefficient, inflexible and with poor accessibility and spotty coverage.[31] The neoliberal reforms of the healthcare and education systems in the early 2000s further exacerbated the situation as families were forced to spend more on such services.[32] As a result, households have had to squeeze their consumption to save for potential unemployment as well as healthcare and education, a system of 'fear-driven precautionary saving that inhibits the development of a more dynamic consumer culture'.[33]

Another pronounced phenomenon when it comes to private consumption has been a rapid increase in household debt in the balance sheet, particularly in medium- to long-term consumer debt. Since the global financial crisis in 2008, China has significantly increased the leverage across the public, corporate and household sectors.[34] China's household debt-to-GDP ratio has surged from 18.8 percent in 2007 to 63.5 percent in the second quarter of 2023, a significant increase of 44.7 percentage points and inching closer to the IMF's warning point of 65 percent, indicating potential financial risks.[35] The consistent rise in household leverage is all the more extraordinary compared with the trend in other major economies during the same period (Figure 5).

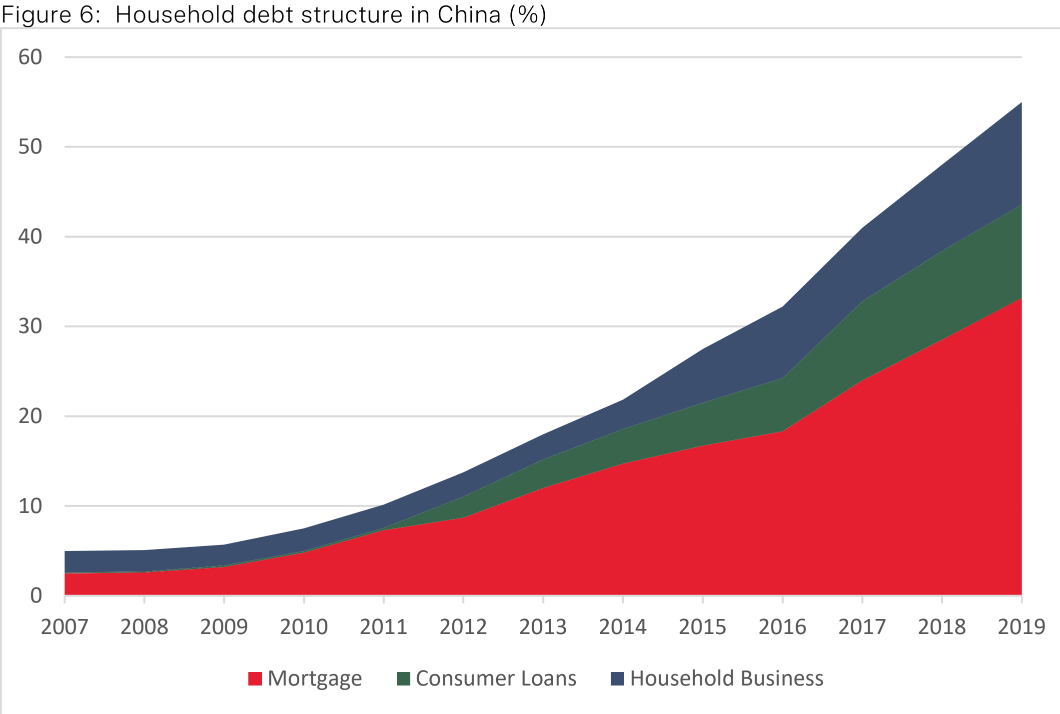
Figure 5: International Comparison of Household Debt (Debt/GDP, %)



Source: IMF database.[36]

The rapid increase in household debt is partly due to an increase in consumer loans (Figure 6), which include both bank-based lending in the form of credit cards and non-bank lending in the form of car loans and the increasingly popular internet finance that provide easy access to credit for household borrowers.[37] For example, according to an annual consumer credit report, online credits to household exploded 400 times, from RMB20 billion in 2014 to RMB7.8 trillion in 2018.[38]

Figure 6: Household debt structure in China (%)



Source: China Insurance and Banking Regulatory Commission database.[39]

Mortgage lending makes up more than half of China's household debt, accounting for more than 60 percent in 2022. The scale of the mortgage market reflects high housing prices, which is caused by substantial housing demand from urbanisation, migration, upgrading, as well as limited channels of investment under financial repression. High property prices have also been the result of high land prices caused by local governments seeking extrabudgetary revenue from land sales. By deliberately limiting the supply of residential land, local governments are able to sustain high prices for residential land in order to subsidise low prices for industrial land in a bid to lure investment. The developers would, in turn, pass on their land acquisition costs to property buyers.[40]

Rising housing expenditures tend to reduce private consumption. On the one hand, there is a wealth effect as rising property prices and easier access to credit in a more liberalized financial system encourage greater consumption. A number of studies have shown that the expansion of household debt has a short-term effect of promoting household consumption in China. For example, Song and Zanghave revealed that households with debt have higher consumption expenditures than those without debt, and their consumption structure is also being upgraded.[41] On the other hand, there is a crowding-out effect as rising household debt and debt repayment tend to erode household liquidity, and hence restrains consumption. There is a risk that long-term economic growth will be suppressed under excessive debt.[42] Additionally, Huang and Guo analysed microdata using the Engel coefficient from a redistributive perspective, and found that household debt reduces the Engel coefficient of low- and middle-income households, and the liquidity constraint and uncertainty of household debt tend to strengthen their precautionary savings motives. On a macro level, as Cocco and Marco et al. pointed out, debt increases can promote consumption and economic growth in the short term (less than one year).[43] However, in the long term, for every 1 percent increase in the household debt-to-GDP ratio, there is a 0.1 percent *reduction* in the economic growth rate. When household debt exceeds 60 percent of GDP, its long-term negative impact starts to kick in. When it exceeds 80 percent, it starts to negatively impact on economic growth. Furthermore, the International Monetary Fund (IMF) defines excessive credit as the level when the increase in private debt-to-GDP exceeds a stable trend, predicting that a 1 percent increase in the ratio will lead to a 0.5 percent persistent decrease in private consumption in advanced countries after five years and up to 2 percent persistent decrease in emerging and developing countries.[44]

Therefore, while China's government promotes policies that make borrowing easier for households in sustaining the real estate investment, it must proceed cautiously. Tang and Zhang note that the share of Chinese households whose total debt exceed their net assets (those technically broke) have increased from 13.9 percent to 21.2 percent between 2015 and 2017 alone.[45] Therefore, it is safe to say that the household sector's debt size is ‘excessive’. As suggested by previous research, China's household debt has already exceeded 60 percent of GDP, increasing the risk of default and may constrain household consumption.

The demographic challenges

One of the structural issues in China's domestic consumption is its shrinking and aging population. According to the National Bureau of Statistics, the total population decreased 850,000 from the previous year, representing the first decrease in absolute terms in 61 years. The number of births was also down by 1.06 million in 2022 from the previous year, marking the second consecutive decline. Meanwhile, the population of those aging at 65 and over has exceeded 200 million, and the aging rate has more than doubled from 7.1 percent in 2001 to 14.9 percent in 2022.[46] Such demographic changes in China, in the form of a declining and aging population, are likely to pose profound challenges to boost private consumption and the economic rebalancing.

Firstly, a smaller population means smaller consumer base, resulting in a reduction in consumption expenditure in absolute terms. Secondly, with an aging population, i.e., an increase in elderly households, overall consumption tends to decrease due to decreased labour compensation. As seen from Table 1, the average annual consumption expenditure per household headed by those aged 65 or older is lower than that of households headed by someone under 64, accounting for only about 60 percent of the total. In other words, if the gap in consumption expenditure between the two household groups continues to widen, aging itself could shrink the scale of household consumption, hinder the strategy for expanding domestic demand, and even put downward pressure on economic growth.

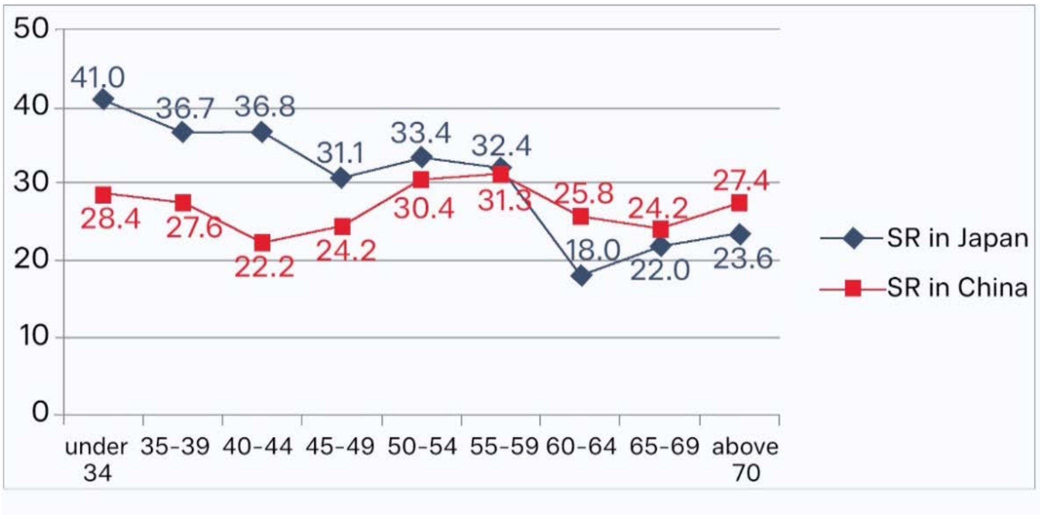
Table 1 Annual consumption expenditure per household by age group

	65 years old and over	64 years old or younger	Consumption Expenditure Difference (Yuan)
2013	28,942	50,212	-21,270
2015	37,181	58,388	-21,207
2017	38,641	58,231	-19,590
2019	35,324	58,450	-23,126

Source: CHFS database.

According to the life cycle hypothesis (LCH), one tends to smooth out consumption level during the entire life cycle, resulting in higher savings at a younger age and lower savings at an older age.[47] However, this does not apply to the savings behaviour in China. As shown in Figure 7, the household savings rate by age group in China (and Japan) tends to *increase* again in the 60s against the LCH predictions. Tang (2021) found that when the percentage of elderly people aged 60 and above in the household increases by 1 percent, the household savings rate increases by 3.2 percent when defined as the aging rate.[48]

Figure 7: Savings rate of China and Japan by age groups (%)



Note: SR = Saving Rate.
Source: Tang and Zhang (2022).[49]

There are several mechanisms behind the increase in savings rate among the elderlies in China. First of all, the wider access to the pension system in recent years in an emerging aging society tend to foster household savings. Research shows that households receiving pensions and with higher aging rates tend to have higher savings, especially for urban households.[50] One important reason is that household financial assets have not accumulated with the age of the household head ('unrich before old'), largely due to low income, unexpected big-ticket expenditures, and/or poor financial literacy and planning. In addition, while China has established a modern pension system, the latter is plagued with fragmentation among the provinces, division between urban and rural areas as well as coastal and inland regions, and compartmentalisation along a socio-political hierarchy, benefiting mainly the state sector. As a result, those without privileged status in the pension system lose out and are forced to strive for savings to sustain life after retirement.

Another reason for the high savings rate among elderly households has been the presence of bequest motives, which is an economic phenomenon of intergenerational transfer of wealth that entails accumulation of wealth presently for inheritance by heirs in the future.[51] Based on the dataset from the China Household Finance Survey (CHFS), Tang and Zhang found that bequest motives positively affect the savings rate of elderly households in China.[52] In particular, the elderlies with high bequest motives save more than those with low bequest motives. This can be discussed from three perspectives. First, bequest motives have a stronger effect on the savings of elderly households in rural areas than in urban areas. This is because in rural areas, the traditional custom of children taking care of their parents is still strong. This is believed to strengthen intergenerational bonds and motivate elderly people to leave an inheritance for their children. In addition, since the income level of rural households is low, it is expected that rural elderly households would have to save more because of higher levels of financial insecurity. Second, bequest motives have stronger positive effects on the savings of the middle and low asset groups compared with the high asset group, in that under strong bequest motives, the latter would need to save more as their asset pool decreases. Finally, elderlies have to take into account the socio-economic status of the bequest beneficiaries. Such status is often embodied by occupation (public sector vs. private sector jobs) and educational level (university graduates vs. high school leavers or lower). The study concludes that the lower the beneficiaries' socio-economic status, the more the motivation to leave an inheritance and therefore the higher savings by elderly households.[53] Hence, the strong, traditional, and altruistic family bond in the context of increasing income inequalities in an aging Chinese society has ultimately hijacked household savings and in turn repressed consumption.

Repressed household consumption: Which way out?

We argue in this paper that insufficient domestic demand and repressed household consumption are essentially built-in features of China's investment- and debt-driven growth model. Under this growth model, national income and distribution are systemically biased against labour under specific and various production, financial and political institutions. Households are further exploited by the land revenue regime of local governments through exorbitant land prices that push up housing costs, which in turn represses consumption. Increasing costs of living and uncertainty reduced incentives for population reproduction, resulting in negative growth in population, whilst increasing income inequality further encourages household savings to help the younger generations in need. Low levels of private consumption are, therefore, a structural issue of China's growth model that essentially entails a massive transfer of wealth from the (non-tradable) household sector to the (tradable) industrial/investment sectors. Over the years this has resulted in increasingly unsustainable levels of household leverage (and rising), which is bound to have a negative impact on an already slowed-down economy.

Challenges of economic rebalancing thus entail shifting the growth model to one that is more centred on private consumption, a new growth model that has to strike a more delicate balance between more efficient investment and more sustainable domestic demand. A series of institutional reforms are essential in addressing these challenges.

First, measures are needed to increase labour's share in national income, through both market-based primary distribution and government-led secondary distribution. For the former, meaningful representation of labour's interests should be protected and fostered, which entails reforming the national trade union system, as well as facilitating non-government organisations and activists in playing a role in organising labour. It also entails less intervention by local governments in judiciary processes to ensure fair trial over industrial disputes, and proper enforcement of the labour law. For the latter, the government, particularly the central government, should increase its transfer payment to households. Redistributive policies could help reduce income inequality, which has a direct and profound impact on household income and consumption, as well as reducing bequest motives behind intergenerational savings. This includes increased spending on public education and healthcare systems, which will effectively reduce the precautionary savings of households. This is especially needed for inland regions where there is a wide gap in the provision of such services compared with their coastal counterparts. Moreover, the central government would need to establish a nationwide and more unified pension system, which has multiple benefits in fostering labour mobility, expanding membership and savings base, and ensuring stable expectations and financial planning by retirees. China should also promote the superannuation system in both public and corporate sectors that effectively complements the pension system. The resultant increase in financial security will help reduce savings by seniors as well.

Second, fiscal reforms are needed to optimise the balance of revenue and spending obligations between central and local governments. This will greatly reduce the incentives for local governments to seek extrabudgetary revenue, which has led to a highly distorted land market that has been behind high land prices and high levels of local government and household debt. The central government has taken various measures to reduce local government debt by allowing the latter to issue special-purpose bonds with much lower interest rates. A correction in the real estate market could reduce household leverage, but the government needs to walk a fine line between reducing inefficient investment in the housing sector and not causing a prevailing market panic through a plunge in housing prices. Moreover, further liberalisation of the financial system should help increase household asset income and consumption through more market-based interest and exchange rate regimes.

However, the most daunting challenge in addressing weak domestic demand and consumption are likely political resistance from vested interests associated with the old growth model. As Baccaro and Pontusson[54] remind us, specific growth models are underpinned by their own 'growth coalitions', which is defined as 'an enduring cross-class coalition of sectoral interests'. In China's case, the growth coalition that is associated with its growth model has included the government, the state-owned enterprises, state banks, and the industrial capital with privileged access to the government. In other words, the winners of the current growth model have been the Chinese state and its associates, whilst the losers have been the households. As Naughton argues, "China's relatively weak performance in achieving broadly redistributive policies, social fairness, and improved public goods provision appears to reflect the limits of responsiveness and the power of entrenched economic and political interests."[55]

A new growth model that centres on domestic consumption would entail a counter, institutionalised transfer of wealth from government to the households. Ultimately, this entails a dismantling of the old, state-centred growth coalition, and requires rule of law that ensures the representation and protection of private interests in policy process and public decision making. However, given the power of the 'entrenched economic and political interests' in the state sector, particularly under the local government-bank-SOE nexus, the structural reforms essential to fulfil a healthy 'internal circulation of the economy' would be a most difficult task indeed. The command-and-control style of the current leadership would only emphasise the importance of the state economy, and the geopolitical rivalry with the United States would further constrain the political space for the Chinese leadership in undertaking major domestic redistributive reforms against its key political constituency. This means China is likely to be trapped in the current growth model without decisive momentum for the much-needed rebalancing.

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