



FOREWORD

The ANZ Research In-Depth series continues with this timely paper about the next phase of evolution for the Chinese economy. Sleeping Giant: China's Consumer describes the tectonic shift currently underway in the Chinese economy as it moves from a growth model based on investment to one based on consumption.

The shock wave from that shift is being felt around the world, with China already the number one market for a range of expensive luxury items, but the move has only just begun. Growth in spending by China's middle class has the potential not only to transform China's economy, placing it on a more sustainable path for the future, but also to rebalance the global economy.

Recent volatility in China's stock market, uncertainty about the RMB's outlook, and downward revisions to China's growth forecasts all appear to cast doubt on this positive vision for China's future. However, in our view, these developments are consistent with the first painful steps towards a more open economy, which is a fundamental prerequisite for a rise in Chinese consumption.

More specifically, the Chinese government is rightly focusing on reforms to pension and medical insurance schemes, in order to give consumers greater confidence to spend. Just as importantly, it is pressing ahead with the liberalisation of its financial system. From the government's preliminary moves to float the RMB, to the relaxation of regulations around consumer credit and financial services, China is gradually opening its economy to international markets and increasing the range of financial products that Chinese citizens can access.

China's transition to a market-oriented, open economy will not be an easy one, as we are seeing in global market ructions today. Moreover, an economy driven by consumption will mean lower growth for China. Nevertheless, ANZ Research firmly believes it is the right course for China to chart and the world will ultimately reap the benefit in the form of a more stable global economy.

In addition, new opportunities will emerge for businesses everywhere as the discretionary spending power of China's middle class rises. In recent decades it has been commodity producers and participants in the global supply chain which have benefited most from China's expansion, but the next wave of opportunity will lie with service providers, especially in tourism, education, financial services and health care.

I hope you enjoy *Sleeping Giant: China's Consumer.* It is our intention to spark a wide ranging debate about these issues and opportunities, given their importance to the global economy over the next 15 years and beyond.

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SLEEPING GIANT: CHINA'S CONSUMER

Key Points

- China's private consumption is already a significant force in absolute terms, but at 38% of GDP it is still well below the rate seen in other economies. Over the next 15 years we expect China's consumption share to rapidly approach global norms, despite a slowdown in overall GDP growth.
- The Chinese authorities are working to rebalance China's economy by increasing consumption and reducing the reliance on investment and exports for economic growth.
- In particular, a range of reforms is being implemented to increase household incomes and lower precautionary savings. Those initiatives include widening medical insurance, pension reform, labour law amendments, and land reform all of which should give the Chinese consumer greater confidence and capacity to spend.
- We also expect the extension of consumer credit and rapid growth in online sales to play their part in stoking private consumption.
- We believe China's growing urban middle class will more than double its spending over the next 15 years, helping lift China's consumption as a portion of GDP to almost 50%. By way of comparison, that means China's consumption in 2030 would exceed GDP in the US today.¹
- Potential risks to these projections include delays in the liberalisation of China's financial system or delays in the implementation of the reforms mentioned above.
- Our projected increase in Chinese consumption will have significant implications for the global economy.
 On the positive side, growth in Chinese consumption and a reduction in China's savings could help rebalance the global economy, especially if it reduces its reliance upon the US consumer as a final source of global demand.
- On the negative side, it may mean lower growth for China. In addition, fewer exports from China to the G3 will mean some Emerging Asian economies (which are currently exporting components to China for assembly) may have to develop new growth strategies.
- However, new opportunities are already arising as China's urban middle class grows. For Australia those opportunities include education, tourism and services on the ground in China.
- As a result, we expect Australia's exports to China will almost double to around USD175bn by 2030.

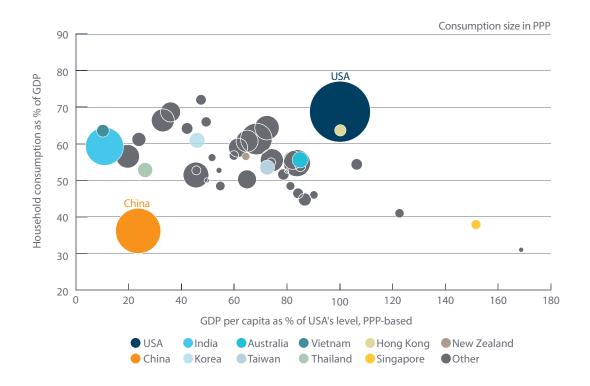
Assuming a USD/CNY exchange rate of 6.4, China's GDP will be approximately USD36.3tm in 2030. China's consumption would therefore be USD18.2tm, which would exceed US GDP in 2014 USD17.4tm).

Chinese consumption is already a potent force

China has now become the world's largest market for some luxury car makers while sales of other luxury items such as watches and high-end fashion are also booming. Beyond the growth in sales at home, consumption abroad has skyrocketed too, with Chinese tourism-spending hitting a record USD164.8bn last year, almost 30% higher than the year before. While these developments show Chinese consumption is already being felt around the world, the truly remarkable thing is the potential for growth.

At 38% of GDP, consumption in China is unusually low. In most of the world's economies, consumption lies between 50% and 70% of overall economic activity (Figure 1). The Chinese economy has been characterised by extraordinarily high rates of investment and saving. The next stage of the 'China Story' will be a moderation in saving rates and a rapid growth in consumer spending. In addition, disposable incomes (per capita) in China's urban regions are set to almost quadruple over the next 15 years. So we could be seeing the beginning of the most significant change in global consumption patterns since the rise of the US middle class at the turn of the 20th century.

FIGURE 1. China's private consumption is about half of the US consumer market, 2014



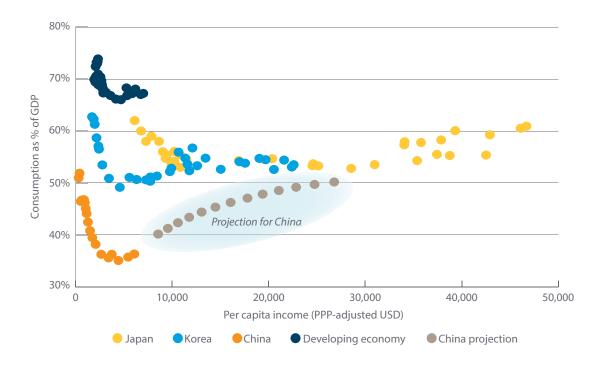
Note: For international comparison, the size of consumption is valued in PPP terms. Nominally, China's household consumption totalled USD3.8trn in 2014, almost as large as Germany's GDP.

Source: World Bank, IMF, OECD, ANZ Research

Chinese consumption still has a long way to go

Consumption as a share of GDP normally starts off high when incomes are low, then falls, and ultimately rises again (Figure 2).





Source: IMF, ANZ Research

Looking at each of these three phases in turn:

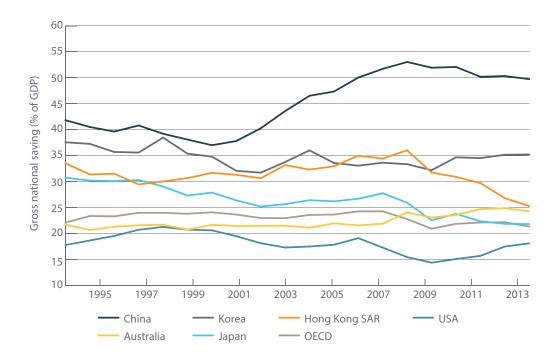
- Initially, consumption share is high as most household income is spent buying basic necessities like food.
- The consumption share then falls due to a rising portion of GDP going towards investment particularly investment in infrastructure needed for industrialisation.
- A final increase in the consumption share reflects a fall in investment once the necessary infrastructure for industrialisation is in place. It also reflects that incomes have normally reached a level (around USD10k per capita) where people can afford luxury goods and services.

In China's case, the infrastructure build is still underway, but the rate is expected to slow. In addition, China's per capita income is now at the tipping point of USD10k. Thus, China's consumption share should be poised to climb steeply (Figure 2). It will need to do so if China's economy is to navigate the coming decades without experiencing a crisis.

Rebalancing the Chinese economy

China's economy has been growing at roughly 10% per annum since 1990, but the composition of its growth has been heavily skewed towards investment. China's savings rate and its rate of investment have been unsustainably high for a long time (Figure 3).

FIGURE 3. China – a savings rate comparison



Source: IMF World Economics Outlook April 2015, OECD, ANZ Research

If these imbalances are not addressed, the economy will be vulnerable to a financial crisis. But equally, if investment is to be reduced, consumption will need to step in to support growth or the economy will risk going into recession. Increased spending by Chinese households will be fundamental to the future stability and growth of the economy. In recognition of this, the Chinese authorities are enacting policies aimed at reducing excess savings, increasing household wealth, and improving financial infrastructure.

One key raft of reforms is intended to reduce the level of precautionary savings in China – that is the tendency for households to save for an unsupported retirement or unforeseen medical expenses. Ongoing pension reform by the Chinese authorities and a planned deepening of existing medical insurance schemes should lower precautionary savings in China and release funds for consumption. Other reforms are aimed at lifting household wealth, especially in the more impoverished regions of rural China, including land reforms, labour law reforms and aggressive urbanisation targets.

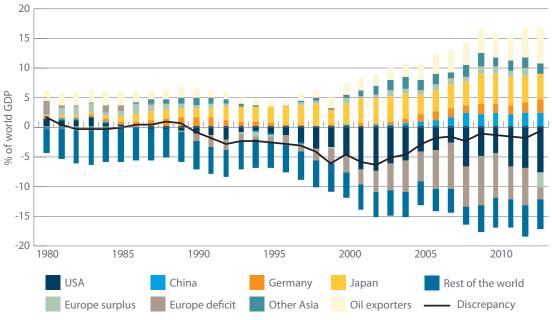
Perhaps most importantly of all, China is modernising its financial system. Regulation of the core banking system is being gradually relaxed while new financial services firms are emerging. This will improve the household sector's access to credit and financial management products. These reforms go hand in hand with the opening up of the financial system to international markets – the most recent example being the shift towards a floating RMB regime in August 2015. The effect of these changes will be to increase the range of financial products and markets that the Chinese people can access, helping lift the return on their savings.

The implications for China and the world are profound

Increased consumption in China will have significant benefits for the wider world. China's sheer scale means its excess savings are causing distortions in the global economy. For example, the US economy has absorbed much of China's excess savings, contributing to a large current account deficit in the US.

If China continues to expand at a faster rate than the global economy, it will become harder for foreign demand to continue absorbing China's excess savings. In particular, some countries currently running current account deficits have seen their net financial liabilities grow to the point where further deterioration could jeopardise global financial stability (Figure 4).

FIGURE 4. Global net foreign assets (stock) of imbalances (% of world GDP)



Source: IMF, ANZ Research

The expected changes should reduce those risks. Increased consumption in China (and a reduced reliance on exports) should decrease its current account surplus, lowering the combined net deficit of its trade partners. Most of this adjustment will probably take place in the US, leading to a more balanced economic profile for that country.

On the downside, these changes will likely mean slower growth for the world, fewer import opportunities into China, and a challenging period of structural adjustment for some economies (especially emerging Asia countries that are heavily reliant on the export of parts to China). In aggregate, global financial stability will be enhanced by the rise of the Chinese consumer and new opportunities should emerge for retailers globally.

New opportunities

Consumption patterns in Taiwan and Hong Kong offer us some clues as to where the new opportunities will emerge. As Taiwan's economy matured last century, its spending patterns shifted away from food and other basic necessities in favour of household items and services. We expect overall spending in China to move in a similar direction over the next 15 years and we believe affluent consumers in cities like Shanghai will adopt Hong Kong's pattern of higher expenditure on electronics, jewellery, cars, education, medical services, and packaged tours.

2013 2030 3.9% 3.0% 6.2% 10.0% 25.0% 12.7% 35.0% 18.0% 5.0% 15.2% 16.0% 15.0% 10.6% 6.7% 9.7% 8.0% Food Transportation and telecommunication Clothing Education and recreation Residence Medical Other Household facilities and items

FIGURE 5. China's urban consumption trends

Source: China Statistical Yearbook, ANZ Research

In Australia's case, the changes could present some challenges as well as opportunities, because China's move away from investment-led growth (especially infrastructure construction) means reduced demand for commodities. While Australia's commodities will still be needed for China's growing housing, car and energy markets, Australia will need to adapt to take full advantage of the emerging opportunities in the services sector. In particular, the tourism and education sectors can expect strong growth as more Chinese citizens travel to Australia for leisure and study. As a result of emerging opportunities like these, we project that Australia's exports to China will almost double by 2030 but the transition could be a bumpy one.

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