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From the Desk of...

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Rebalancing the Global Economy; consumption trends in the US and China.

In economic policy debate, rarely has so much been blamed so squarely on a single cause. The so-called 'global imbalance' of over-consumption in the US and under-consumption in much of Asia (and China especially) from which so many macroeconomic ills are seen to have emanated, is also deemed a major contributing factor to the global financial crisis. The imbalance undoubtedly exists. In early 2008 private household consumption in the US accounted for about 72% of GDP and in sharp contrast it was 37% in China. So there would seem to be a simple solution; the US should consume less and China more - problem solved.

But what level of consumption, for both American and Asian (and Chinese in particular) households, could be considered appropriate, and, hence balanced? This question is much more difficult to answer than it first seems. It turns out that it is a lot easier to spot over- and under-consumption but much messier trying to determine the "right" level of consumption.

From the point of view of GDP accounting it's relatively straight forward to spot the imbalance. By definition, national income minus the sum of private consumption, investment and government expenditures must equal exports minus imports, which in turn must equal to the current account balance. If there are persistent current account deficits, as in the case of the US, then the US is living above its means. In the case of China, it is the exact reverse where there are current account surpluses; hence China is living below its means.

So far so good. So should the right amount of consumption be simply defined as that which would produce a balanced current account? The current account can be balanced, however, by changes made in not one, but three variables: private consumption, investment and government expenditures. What, then, is the right combination of the values of the three variables that would lead to a balanced current account? Matters become even more complicated when we take into account the objective of economic growth, which often over-rides that of a balanced current account, at least in the short term. How the three variables of private consumption, investment, and government expenditures are combined will certainly affect growth and income distribution in ways that may or may not be desirable, even if it does lead to a balanced current account. So a balanced current account turns out to be not that useful after all in determining the "right" level of consumption.

Another alternative is to look at the savings side of the equation, since saving is the flip side of consumption. However, the standard text book explanations of saving behavior are at best incomplete. In the text book models, people are assumed to save according to rational calculations of how much they need to put aside for future needs, including the funding of their eventual retirement. Hence these models suggest that there is a "lifecycle" pattern in which people tend to save while they are young, building up a nest egg of saving. As they get older they begin to spend it. Thus, aggregating the savings of different population segments by age would give the "right" level of savings for the economy, hence the "right" level of consumption. But as has been repeatedly observed, people's actual saving behavior is very haphazard. Data show that most people do not plan when and how much they should save at all, let alone being rational in their planning. Instead, saving is largely based on decisions that are highly influenced by circumstantial conditions, including how much people feel that they have to catch up with the Joneses, how optimistic or pessimistic they are about the future, how wealthy they feel and their time horizon when thinking about saving (that is, when they do think about it).

Apart from these complicating issues, we also need to consider the important distinction between two sets of countries: low per capita income developing countries and high per capita income developed countries. For developing countries to catch up, they need to aim for higher real growth than the developed countries, and for this to happen more investment is needed. Investment is fundamentally the single most important factor in accelerating economic growth. Investment means building new factories, acquiring new machinery, improving transportation and communications infrastructure; in other words, getting better tools for the labor force to work with. Investment is also critical in bringing forth new and more productive business models to replace the old. Investment in health care and education in turn improves the quality of the labour force, and productivity increases when healthier and better educated workers (human capital) are matched with better tools, supported by more efficient infrastructure and organised more effectively and productively.

A primary feature of the developed countries, when compared with the less developed ones, is their much higher capital stock per capita. The developed countries are developed precisely because they have accumulated high levels of capital stock through past investment, thus their workers are well equipped with lots of tools, including up-to-date equipment and know-how. It is therefore no surprise that workers in developed countries are more productive and earn a lot more, even though they may work fewer hours and seem to live life at a more leisurely pace than workers in developing countries. The differences in capital stock per capita between developed and developing countries can be huge. The average Swiss has a capital stock close to US$1.3 million in 2008, or over 53 times bigger than in China, and over 91 times bigger than in India. Japan has the second highest capital stock per capita among the developed countries, followed by the US, UK, Canada, and Australia.

To achieve higher growth, developing countries must then have a higher level of capital stock per capita, and to do that they must invest more. With their typically under-developed capital markets and less efficient financial system, many developing countries have no choice but to fall-back on high levels of domestic savings, thereby saving their way to higher growth.

To achieve higher growth, developing countries must then have a higher level of capital stock per capita, and to do that, they must invest more. With their typically under-developed capital markets and less efficient financial system, many developing countries have no choice but to fall-back on high levels of domestic savings, thereby saving their way to higher growth. This is exactly what happened in East Asia and Southeast Asia in the past half a century. Indeed, Singapore and Korea made it to the rank of the developed countries by raising their capital stock per capita to US$545,480 and US$297,288 respectively. And, today, investment accounts for close to half of GDP in China, funded almost completely by domestic savings. And China's rate of saving is one of the highest in the world. China's gross aggregate savings (personal, corporate and government combined) hover around half of GDP in recent years.

The statistical relationship between investment and growth of real GDP is very clear for the developing countries. With more investment, higher growth follows. With the much lower capital stock per capita, there are simply a lot of opportunities to provide better tools and equipment for workers, even at unchanged levels of technology. However, the correlation is much less clear for the developed countries. This is not surprising. Given their much higher levels of capital stock per capita, an incremental increase in capital stock, everything else being equal, would have only marginal impact on growth in developed countries.

Things look very different when it comes to consumption. There is a clear statistical correlation between consumption and growth for the developed countries. This makes sense. Given their already high capital stock, an increase in demand through higher consumption could raise capital productivity, as long as the economy is not already running at full capacity, leading to higher output per unit of resource employed. The impact of higher consumption on growth is much more muted for the developing countries, however. This follows from the earlier discussion that investment, being the prime mover of growth for developing countries; affect growth much more so than consumption.

Thus, there is a natural propensity for developing countries to leverage investment more to drive growth and for developed countries to rely more on rising consumption to generate demand that keeps workers employed and businesses profitable. In discussing the rebalancing of the global economy, these different tendencies between the developed and developing countries must be taken into account and the rebalancing process cannot be mechanically interpreted as simply getting Asian (and especially Chinese) consumers to save less and spend more, and vice versa for American consumers.

In the aftermath of the global financial crisis, a contraction in private consumption in the US is inevitable. The massive increase in household debt in the US before 2008 was intertwined with rising property values. It has been estimated that between 2002 and 2006, some 60% of the total new debt taken on by US households came from their ability to cash in on higher home values. With the crash of the housing market, this "ATM" (their rising home values) that US households had been using has now been shut down. In fact, it is estimated that around 20% of home owners are saddled with negative equity, i.e. what they owe in mortgages are higher than what the properties are worth. Meantime, unemployment has risen to above 10%. Households have also begun to save more. All these developments point to one thing: lower household consumption in the foreseeable future.

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How much lower? The answer to this question is important as it potentially constitutes one-half of the solution to the global imbalance. I expect GDP growth in the US to average about 1.2% a year over the next five years (2010 to 2014); and household consumption to grow by only 1% a year (a far cry from the 6% annual average growth of the recent past). Thus, private consumption's GDP share will drop from the 2008 level of 72% to around 68% by 2014. This will mean lower imports; and if American exports can also rise on the back of a weaker US dollar, then the current account deficit will decline, perhaps faster than expected.

It is a very different picture in China. Pundits of various stripes have routinely blamed Chinese households for saving too much, often citing China's persistent and high savings rate. This is, however, a case of mistaken identity. The real culprit of China's high savings is the corporate sector, not the households. On average, the corporate sector accounted for up to 60% of China's aggregate savings in recent years.

Chinese households do save a lot, around 20% of their disposable income very consistently over the past decade. But they do so for very good reasons. First of all, they save for precautionary reasons such as making provision for future health care and education needs for their children. This is a very important reason for saving because of the One-Child policy. For parents that can afford to do so, they much prefer better quality but expensive private health care should their single child gets sick and they are prepared to pay for private tuition, and even a private school education, to ensure that their single child will be successful in the future. For those with ageing parents, they also need to save more to make sure that they could provide them with financial support, given patchy and insufficient pension coverage.

Apart from precautionary savings, however, the average Chinese household's ability to consume has also been suppressed by low growth in wages. The fact is that the lion's share of China's rapidly rising national income has gone to the corporate sector, not to the workers. The GDP share of total employee compensation in China has been declining in recent years, dropping to 42% by 2007. On the other hand, corporate sector's share of the national income, represented by its operating surplus, has been rising -- almost 39% in 2007. As a comparison, the GDP share of total employee compensation in the US in 2007 was 57% and corporate surplus 25%. The fact of the matter is that wage growth in China has consistently lagged the growth of productivity, leading to a situation where households' ability to consume, even if their precautionary savings is reduced, is much lower than what it could have been.

The impact of the global recession has been like shock treatment for China; the government has become fully aware of the fact that weak private consumption at home deprives the economy of a robust, automatic stabiliser that can mitigate the sudden collapse of external demand. The massive increase in liquidity in the form of bank lending to local governments for infrastructure projects has bought time for the government to implement much needed structural reform to rebalance China's domestic economy.

The fiscal package has jump-started the increase in spending on social welfare, especially in health, education and pensions, all key factors that drive up Chinese households' precautionary savings. Higher spending on social welfare will be a standard feature in the government's budget in the coming years. It is also expected that a comprehensive tax reform will be announced and implemented in the next year or two, with state-owned-enterprises required to pay dividends to their shareholder, the government, and royalties for resource extraction. The additional government revenue will be used to fund the higher social welfare spending. At the same time, income tax will be lowered for households.

With the expected weaker growth in exports (there are simply no realistic prospects of returning to the halcyon days of 30% growth year-on-year any time soon, the obvious alternative is to expand the domestic service sector for income and employment growth. As it happens, domestic services have been estimated to be more employment-intensive than exports for the equivalent growth in demand; roughly one-third higher. And in the context of China's rapid urbanisation; expansion in demand for services could also be expected to be robust, including higher pay professional services. This would then mitigate the highly undesirable trend observed in the declining share national income of employee compensation, allowing wages to grow faster than in previous years.

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These trends – improving social welfare, faster wage growth, tax reform, better paid employment creation in domestic services - will collectively raise private consumption's GDP share in the coming years. Assuming that China's real GDP growth will average 8% a year in the next five years (2010 to 2014) and that the GDP share of compensation of employees returns to the 2001 level of 50% by 2014 while household savings drop to 15% of their annual disposable income, then private consumption in China will rise to 49% of GDP -- up from 37% in 2008.
Should this projection come anywhere close to what actually happens in the next several years, then the foundation would be set for lowering China's current account surplus. A critical new development, however, is for the Chinese currency to begin appreciating again, which I expect to happen as early as the second half of 2010. This will increase households' spending power on imports, discourage excess investment in manufacturing (and in the obverse, raise investment in domestic services), thus reducing the trade surplus.

Such a development would be very positive for rebalancing the global economy. If, by 2014, private consumption in the US could dip to 68% of GDP, and for China's private consumption to rise to 49% of GDP, then their respective current deficit/surplus could be reduced to a more manageable level. However, this will certainly not happen overnight, nor will it progress in a linear fashion -- bumps and reverses are to be expected.

There is simply no quick fix for the so-called global imbalance. And it is not a mechanical matter of balancing the current account, whether it is in the US, China or elsewhere. As discussed above, there are positive developments in both the US and China which, for domestic reasons, could reduce the global imbalance in the coming years

In fast growing developing countries, investment is likely to stay high and correspondingly private consumption will be relatively low. It would therefore be folly to view the high GDP shares of private consumption in developed countries as the benchmark to which developing countries are supposed to conform.

About Dr Yuwa Hedrick-Wong and The Insight Bureau

Yuwa Hedrick-Wong is a highly respected global economist and Asia business strategist, based in Singapore. He is the author of four books on Asia consumer markets and is the economic advisor to MasterCard International Worldwide where chairs and coordinates MasterCard's MasterIntelligence Knowledge Panel, comprising leading economists and business strategists, many of whom are also members of The Insight Bureau's resource network, providing speeches and presentations at business conferences as well as confidential, in-house briefings to senior executives.

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