QNB Economics
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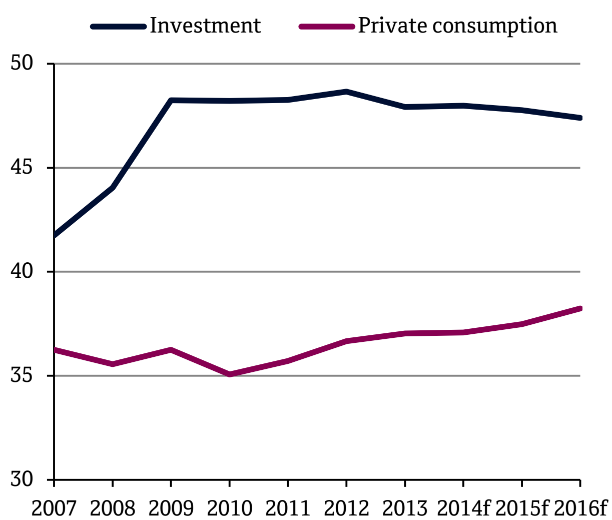
The Rise of the Chinese Consumer

China is undergoing a fundamental shift in its economic structure. For the last 30 years, the Chinese economy has been driven by exports and large public investments that have made it the second largest economy in the world and have lifted more than a third of its people out of poverty. This model of growth, however, is no longer sustainable as it is creating excess capacity against the backdrop of weaker global demand for Chinese exports. Real GDP growth has therefore slowed to 7.7% in 2013 and 7.4% in the first quarter of 2014, still the highest growth rate amongst G20 countries but significantly lower than in the past. The Chinese authorities are therefore seeking to shift the economic structure toward domestic demand based on the rise of the Chinese consumer, where the allocation of resources will be more responsive to market forces. If successful, this transformation will have profound implications not only for the Chinese economy but for the world as a whole.

Since the opening up of the economy in the early 1980s, China has sought to become the world's factory. Through the establishment of special economic zones and heavy public investments, China has reached its goal. In 2013, China was the largest exporter and the second largest economy in the world, with a GDP of USD9.2tn. This is a remarkable achievement, particularly considering that the economy has grown by an average of over 10% a year in the last three decades. In turn, this has allowed more than 500m Chinese to rise out of poverty.

This model of economic development is, however, no longer sustainable. Continued high investments in infrastructure and manufacturing have created excess capacity at a time when the global demand for Chinese exports is sluggish. According to the Financial Times, output is already below 75% of capacity in many industries. In the case of steel, for example, the annual capacity is 1bn tons, while output is 720m tons representing close to half of total global demand. Clearly, additional investments in the Chinese steel industry will only have negative returns. Hence, the need for a new model of economic growth.

Chinese GDP Shares (%)



Source: IMF and QNB Group Projections

This is where the rise of the Chinese consumer is essential for the next phase of Chinese economic growth. For years, Chinese households have been saving more than half of their growing income, partly in response to the lack of a social safety net and a well-developed pension system. With a new set of reforms, the government is now seeking to entice its people to consume more. It has recently relaxed the one-child policy that was put in place in 1979 to control population growth in urban areas, liberalized lending rates, provided more financing for social housing, and generally encouraged households to buy houses and consume more. As part of the latest set of reforms adopted in late 2013 after the so-called Third Plenum, the authorities decided that market forces will play a "decisive role in resource allocation." This implies that farmers will be able to trade their land leases (owning land is still banned in China) or use them as collateral for bank financing. The private sector will also be able to buy into state-owned enterprises through so-called "mixed-property structures." Finally, the reforms envisage the gradual opening up of the Chinese economy to foreign investments through the liberalization of the capital account.

These reforms are already having significant success. In 2013, the services sector already accounted for a larger share of the Chinese economy than industry. In addition, the latest GDP numbers for the first quarter of 2014 show that consumption is growing well ahead of investment and is thus becoming a larger contributor to economic growth. This has immediate repercussions on trade flows. Apple, for example, has just announced record Chinese sales of USD10bn in the first quarter of 2014. These trends are likely to continue in the near future, leading to somewhat slower, but probably more sustainable, economic growth in the years to come.

The change in the Chinese economic structure has also profound implications for the global economy. As domestic consumption becomes a larger contributor to economic growth, Chinese imports from the rest of the world are likely to grow faster than exports, leading to a narrower current account surplus. The composition of imports is also likely to change from raw materials used in industry to consumer goods, with large implications on global commodity markets, especially industrial metals. Higher domestic consumption is also likely to drive up the demand for energy, including cleaner fuels like LNG from Qatar. In addition, as more and more of these imports are denominated in Renminbi, the Chinese currency will become a more important member of the global financial system. Finally, the liberalization of the capital account is likely to draw in a significant amount of foreign capital seeking higher Chinese yields, leading to an appreciation of the Renminbi.

Overall, the rise of the Chinese consumer will transform China into an advanced economy in the years to come. Higher domestic consumption will lead to a more sustainable growth model for China and a more significant role for the Chinese currency in the world economy. In turn, this will have profound implications for the balance of power in the global economy.

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