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China's Consumer Is Stymied by Lack of Credit: Andy Mukherjee

Commentary by Andy Mukherjee

Jan. 15 (Bloomberg) -- The Chinese government's efforts to steer the economy away from exports and investments and toward more vigorous domestic consumption are clearly not working.

The share of consumption in the Chinese economy probably slumped to 36 percent in 2007, the lowest in 20 years, state-run Xinhua News Agency reported last week, citing research by the State Academy of Social Sciences in Beijing.

The main culprit was soaring home prices, the report said.

No doubt housing is getting more expensive.

An official index of new and second-hand home prices across 70 Chinese cities recorded a 10.5 percent gain from a year earlier in November, the fastest on record.

But if property prices are going up, so are incomes.

Besides, even with rising borrowing costs, real interest rates in China are negative. Why would anyone want to curtail consumption to buy a house, earning 4.14 percent on the money kept in his savings account when the annual inflation rate in November was 6.9 percent? Wouldn't a more rational strategy be to take out a mortgage?

``When trend income growth is high, households seeking to smooth their consumption should borrow against future income, especially if real interest rates are low,'' Marcos Chamon, an economist at the International Monetary Fund, and Eswar Prasad, an economics professor at Cornell University, noted in a recent study on the rising savings rates of China's urban households.

Weak Credit

Only 5 percent of China's households had any mortgage debt in 2005, the researchers said. ``Tracing cohorts over time indicates a virtual absence of consumption smoothing over the life cycle,'' Chamon and Prasad said.

The problem of financial underdevelopment isn't restricted to home loans. Since credit checks are perfunctory, cards come with low spending limits and have lukewarm acceptance. Auto finance is still in its infancy. A survey conducted in April last year by consulting firm KPMG LLP and Taylor Nelson Sofres Plc, a market researcher, showed that while 25 percent of car buyers in China had access to finance, few actually opted for it.

Expansion in consumer credit accounted for only 2.6 percent of the household expenditure in China in 2006, compared with 25 percent in India, Michael Kurtz, an equity strategist at Bear Stearns Ltd. in Hong Kong, wrote in a Dec. 14 note to investors.

Boosting consumption, slashing the politically sensitive trade surplus, containing the growth of polluting industries, increasing public expenditure in rural areas and lifting incomes of low-income citizens are all part of China's strategy to boost the quality of the nation's economic growth.

Several Explanations

The share of private consumption in China's gross domestic product, as Morgan Stanley economist Stephen Roach noted last year, was probably the lowest of any major economy in modern history. Economists have given many reasons for this.

First, the Chinese have a strong precautionary motivation to save. State enterprises, which used to provide many subsidized services to their employees and their families, have withdrawn those benefits as part of their ``reform.'' That has shattered the safety net -- especially in education, health care and old-age security -- because of which workers are now more prone to save their incomes than before.

Consumption may also have been hobbled by too much profit being made at the expense of the worker. The share of wages in the Chinese economy fell to 41 percent of GDP in 2005 from 53 percent in 1998, according to the World Bank.

``If China is to rebalance growth towards greater dependence on household consumption, improving the distribution of national income between profit and household income appears to be a quantitatively important factor,'' IMF economists Jahangir Aziz and Li Cui noted in a July paper.

Demographics, Money, Culture

There are other forces, too, at work.

A preponderance of working-age population may have played a part in boosting the savings rate to about half of GDP.

Or perhaps the real reason is monetary.

To keep the yuan from appreciating against the U.S. dollar, the Chinese central bank has suppressed the growth in base money.

That has forced individuals -- who have little leeway to tap foreign capital -- to save more, says Michael Mussa, a senior fellow at the Peterson Institute for International Economics in Washington.

Yet another explanation is cultural. Confucius, the philosopher, had advised the Chinese in 500 B.C. to accumulate wealth by thrift. ``Let the producers be many and the consumers few,'' he had said.

That teaching is more appropriate for the free-spending American consumer. The Chinese could do with a little less production and a little more consumption.

While the bulk of China's high national savings rate is on account of its state-owned enterprises, household consumption is undeniably low. The exact cause of that may be difficult to pinpoint. But, among other things, it must be the government's endeavor to bolster consumer credit.

Officials in Beijing miss no opportunity to say that they accord the highest priority to the task of economic rebalancing.

But with the share of consumption in GDP continuing to decline, it's quite evident that the gap between rhetoric and reality is vast and won't be bridged soon.

(Andy Mukherjee is a Bloomberg News columnist. The opinions expressed are his own.)

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