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China's Consumption Problem and the Global Economy
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China was once deemed the hope of the global economy. With over 1 billion potential consumers, there was and still is strong reason to believe that China can overtake the US as the world's largest consumer society, pulling less developed countries out of debt as they build industries to export products to the Chinese market. These dreams are fading, however, as China's consumer spending fails to keep pace with its rising GDP.

Why are Chinese consumers not spending? There is much talk about the rise of luxury brands in China, the inclusion of yet more Chinese billionaires on Forbes wealth rankings, and the rapid uptick of Chinese students studying at (not inexpensive) American universities. Given this rapid growth in personal wealth, an increase in consumer spending should follow.

There are two main reasons why China's consumers are reluctant to part with their disposable income, and both are relevant to the debate over the direction of the US economy. First, Chinese workers do not have adequate methods to grow their savings over a long period of time. Second, China's social safety net is poorly developed and often exclusionary.

Chinese workers, for the most part, do not have access to a stock market to grow their savings. They can put money in the bank, but interest rates in Chinese banks have not kept pace with inflation, so there is an effective tax on deposits. Thus, banks are a net negative for Chinese consumer savings.

Instead, Chinese families with large amounts of income purchase property as an investment. Middle-class Chinese are heavily invested in second and even third homes, many of which sit empty. But as the collapse of the US property market demonstrated, property investment is a risky business. Many analysts fear a property bubble in China, which, upon bursting, would rob those consumer investments of value and family savings would evaporate. Furthermore, property ownership in China is never guaranteed: people technically purchase long-term leases and cannot own property outright.

Chinese families save more than the global average, between 27 and 38 percent of their income for all but the bottom 10 percent of workers, compared to less than 3 percent in the US. They do so because they have an aging population and an unsure social safety net. In China, social services are distributed through a registration system that ties benefits to the place of birth (or at times, to the place of the mother's birth). Those millions of migrant workers who move to coastal factory boom towns to assemble iPads are generally unable to access state-run health care, unemployment, or retirement benefits because their *hukou* (household registration) is in a different city. While the Chinese are exploring *hukou* reforms that would allow citizens to transfer household registration, many migrants and their children do not have access to public education, state health care, unemployment, or retirement benefits.

Health care costs are rising as consumer costs fall. That means there is no way to predict how much money is needed to cover a cancer diagnosis if you have no insurance or if that insurance denies coverage. As a result, there is an incentive to save in the absence of a well-functioning, low-cost public insurance system. And it is safe to assume that whatever the ailment, medical costs will continue to rise. The same applies to retirement benefits, especially as people live longer and diseases are more treatable. Education costs are also skyrocketing as parents seek greater advantages for their children in a globally competitive marketplace and as mid-career workers go back to school to gain new skills.

Meanwhile, the cost of consumer goods is falling. A flat-screen TV that cost $1,000 in 2007 retails for much less today, eliminating the incentive to consume. Chinese may need every penny for retirement, health care, and education, but they can afford to wait for prices to fall on the latest gadget.

The Chinese government has set the ambitious goal to cover all citizens with universal health care by 2020, and is planning banking sector reform and stock market opening to combat these problems. Yet the barrier to reform is political, not economic. The Chinese Communist Party (CCP) has maintained one-party rule through deliberate favoritism for a government-created middle-class while placating excluded groups with unprecedented economic growth. As the economy slows, the plan that 'some get rich first, others later' is cracking under pressure, creating a need, but not necessarily a will, to reform social services.

For example, the CCP has touted Shanghai's *hukou* reform system as the model for the entire country, neglecting its bias toward the needs of city officials. Shanghai's *hukou* reform model is not set up to ease restrictions but rather to cull the most attractive and highest contributing applicants. Not only can Shanghai administrators restrict the number of people drawing from social services, they can increase the number paying in through the promise of permanent residence, while only allowing partial access to social services in the interim. A professor at China's top university blamed *hukou* restrictions for China's high rates of unemployed college graduates, as close to 25 percent of recent graduates cannot find work.

Hukou restrictions are a glaring inefficiency in the Chinese economic system, but they serve an important purpose for a government that sees high growth rates as the key to maintaining power. Manipulating labor and social service costs allows provinces and cities to keep growth artificially high. As long as the key to promotion in the CCP is high growth rates, further *hukou* reforms will exacerbate inefficiencies rather than bolster China's economy with a flexible and healthy workforce that can shore up consumer spending rather than saving to pay out-of-pocket for social services.

In contrast, Guangdong's powerful Party Secretary and rumored Standing Committee nominee, Wang Yang, has responded to escalating protests and declining manufacturing profits by changing the narrative. Guangdong's focus is no longer high growth rates, but a 'happiness' quotient. In terms of *hukou* reforms, Guangdong has instituted a points system where migrants can earn citizenship status by paying taxes and working specialized jobs, but also by volunteering, donating blood, and providing other kinds of these nontraditional public services. Guangdong therefore represents a region trending toward reform, and Wang Yang's exclusion from the Standing Committee could signal a strong desire by factions close to the top leaders to prevent upsetting the status quo. Still, Wang Yang's overall push to strengthen CCP legitimacy through better delivery of public goods is a way forward for a CCP leadership that, in Xi's words, is "divorced from the people."

Another way to boost domestic consumption is to raise incomes across the board by boosting minimum wages. Should this occur after the 18th Party Congress, expect continued emphasis on high-growth rates as the key to promotion within the Party.

A rise in China's domestic consumption will have implications at home and abroad. Solving the consumption problem will signal progress within the CCP that may temporarily assuage internal critics (although product safety issues will continue to widen the rift between ruling and ruled unless they are adequately addressed through rule of law reforms that allow uniform regulation enforcement). The economy would continue to grow and multinational corporations would continue to invest heavily in domestic production. The developed and developing world would have a market to sell their products, or to sell their inputs to China-based manufacturers.

Without solving the consumption problem, China's economy cannot become the center of gravity for a new global economy. Continuing an export-driven model depends on keeping currency exchange rates low – a major perceived problem in the US and EU – but more importantly, it depends on having a place to sell goods somewhere in the world. As austerity measures tighten Europe's economy, and the US saves more and spends less, China will have to find consumers elsewhere. An export-driven system would continue all the problems outlined above, perhaps boiling over into unplanned political reform.

China knows that it needs to raise domestic consumption, and it knows that doing so is one of the keys to maintaining CCP control. Solving the consumption problem through *hukou* reform and expansion of the social safety net would benefit not only Chinese citizens, but the global economy.

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