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**Toward Higher Household Consumption?  
An Up-to-Date Analysis  
of China's Economic Transition**

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**Alice Ekman**

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**Center for Asian Studies**

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## Executive summary

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This analysis examines efforts to restructure China's economy, taking into account recent government measures and current saving and consumption behaviors of Chinese households. It leads to the following conclusions:

**The Chinese government is engaged in the right direction to stimulate domestic consumption.** Chinese authorities are well-aware of the need to restructure the economy and the 12<sup>th</sup> Five-Year Plan will create space for meaningful progress. China's economy is not a consumer-driven economy at the moment - it is still highly dependent on exports and investments - but evidence suggests that the government has fully engaged in a consumption-driven growth strategy.

**Household consumption will increase step by step.** Reinforcement of the social safety net as well as wage increases should contribute to stimulating household consumption. This consumption will increase progressively, especially in poorer, rural areas. The pace of this increase will highly depend on the capacity of the government to develop widespread and efficient social protection, and healthcare coverage in particular.

**China's economy is likely to restructure in the middle and long run.** The process of economic restructuring will take time, even with strong government will and responsiveness to upcoming economic challenges. For domestic consumption to become a major engine of growth, complex and time-consuming reforms have to be conducted in a wide variety of areas (welfare, employment, control of inflation, development of consumer finance, etc.). In addition to the development of a mature consumption environment, time is also needed to gradually modify household saving and consumption behaviors.

**Two decades will be needed to fully rebalance the economy** towards a more sustainable growth, less dependent on exports and investment, and highly fueled by domestic demand. A reasonable forecast - considering the current obstacles to domestic consumption, government responses, and coordination/execution issues that Beijing may face when implementing the reforms - is that a minimum of 15-20 years will be needed for China's domestic market to fully emerge from East to West, rural areas included, and eventually rank top among the largest markets in the world.

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## Introduction

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For more than two decades, China's economy has been growing at an average rate of close to 10 percent. As a result of this stellar performance, China ascended to the rank of the world's second largest economy in 2010, surpassing Japan. Growth remained high in the first quarter of 2011, clocking in at 9.7 percent.

Despite these remarkably high figures, the share of consumption in China's total expenditure has been low. China's economy relies much more heavily on exports and fixed government investments than on domestic consumption, which only accounted for 49 percent of GDP in 2008, with household spending accounting for just 35 percent of GDP (household consumption accounts for around 71 percent of GDP in the United States and 57 percent in India).<sup>1</sup> An over reliance on exports in particular has made the Chinese economy more vulnerable to shocks associated with foreign business cycles or economic crises, as witnessed by the most recent global economic downturn. If China continues on the same path, economic growth would not only become more vulnerable but also unsustainable.

In order to achieve sustainable growth, China needs to rebalance its economy to rely more on domestic consumers. The 12<sup>th</sup> Five-Year Plan, approved in March 2011, is designed to facilitate this shift by putting in place several large scale measures, including the improvement of the social safety net.

But transforming the nation's growth model will take time and effort. There are significant obstacles to boosting domestic consumption – such as low household income for instance – that government measures may be unable to effectively bypass. This paper presents these current obstacles in detail and assesses the responses proposed by the 12<sup>th</sup> Five-Year Plan.

The analysis is supported by both macro and micro economic data in order to understand the restructuring of the Chinese economy from the perspective of Chinese households (savings and consump-

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<sup>1</sup> World Bank figures, quoted by the National Population and family planning commission of China, March 11<sup>th</sup> 2011.



tion behaviors). It will lead to an assessment of future Chinese domestic consumption and a draft economic transition calendar.

## Low domestic consumption

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### ***Heavy weight of exports and investments in China's economy***

China's economic growth has been fueled by large exports and government investments. They both weigh much more heavily on the economy than domestic consumption itself, which is not only low but has also been decreasing significantly during the past decade.

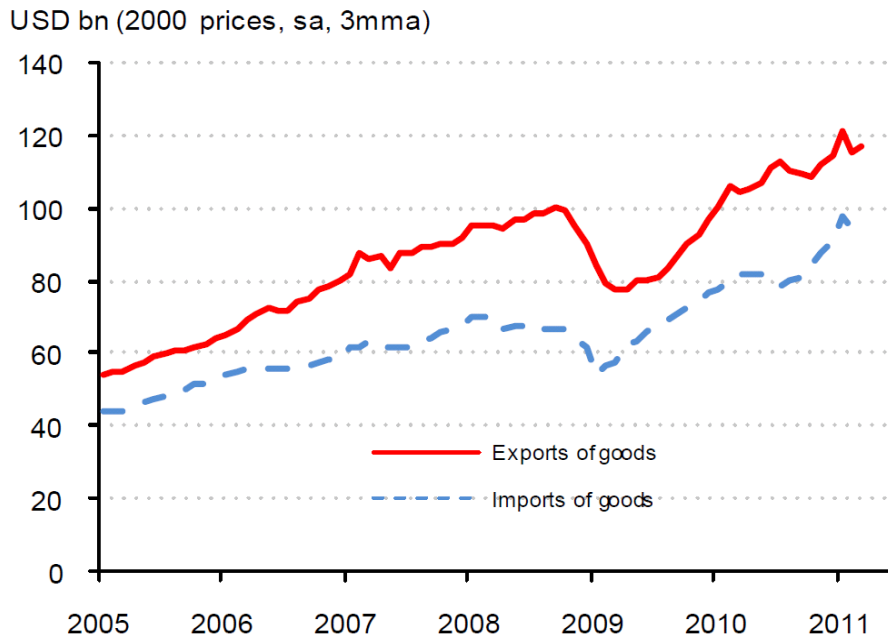
#### **Exports**

China's exports have increased sharply over the last decade, accounting for approximately \$20 billion in December 2000, and totaling over \$150 billion in December 2010. The slowdown of exports was substantial at the beginning of the global economic downturn, and the situation deteriorated further in 2009, but the global economic downturn only had a temporary decreasing effect. Exports continued to expand in 2010-2011 (figure 1). In December 2010, China's exports rose 17.7 percent compared to a year earlier, breaking a 13-month decline in trade as a result of the crisis. In April 2011, Chinese exports hit a record high. According to China's General Administration of Customs, exports rose 25.9 percent in April compared with a year earlier, to \$155.69 billion, exceeding a previous record of \$154.12 billion in December 2010. This increase was even more noticeable as spring is traditionally a weak period for Chinese exports, before large quantities of goods start to be shipped over the summer for the Christmas shopping season.<sup>2</sup>

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<sup>2</sup> *New York Times*, "Chinese Exports Hit Record for April", By Keith Bradsher, May 10, 2011.



Figure 1: Trade volumes have kept expanding<sup>3</sup>

Source: CEIC, World Bank staff estimates, April 2011.

Some analysts<sup>4</sup> rightly point out that a collapse in exports can have severe but surmountable consequences for the Chinese economy. An adjustment of the ratio of exports to GDP in value-added terms shows that the '*adjusted*' export share is high but smaller than generally believed. When export share is expressed in value-added terms, China appears less dependent on exports than its neighboring export-led economies.<sup>5</sup> China is less exposed to export than Taiwan or Singapore, for instance.

Nevertheless, China remains highly export dependent. Such a reliance on exports represents a weakness for the Chinese economy. Trade was one of the major channels for the spread of the global economic crisis at the end of 2008. Chinese exports dropped heavily in 2009 (-19.7 percent in the first quarter of the year) after a seventh successive year of export growth. At the time of the crisis, the US was still China's main export market and the fall in US demand immediately impacted the Chinese economy. The government had to compensate with high and immediate investments.

<sup>3</sup> World Bank figure, in *China Quarterly Update*, World Bank Beijing Office, April 2011.

<sup>4</sup> The Economist, « *An old Chinese myth* », January 3<sup>rd</sup>, 2008.

<sup>5</sup> *Ibid.*

## Investments

If the Chinese economy's dependence on exports is sometimes overstated, its dependence on investments is often understated. Since the opening-up of the Chinese economy, growth has been fueled by huge investments, mostly in infrastructure (roads, highways, dams, power stations, skyscrapers and more recently high speed rail links, etc.). China's economy is still highly driven by investments, which account for over 47 percent of GDP. In all, investment in China has been over 40 percent of GDP since 2005. As a matter of comparison, the investment as percent of GDP in France was reported below 20 percent in 2009, according to the IMF.

With the global economic crisis and the slowdown of the last quarter of 2008, the Chinese government launched a huge fiscal stimulus package. In November 2008, the State Council announced a RMB 4 trillion investment over more than two years. Although it is hard to assess the exact size of the stimulus package (some public expenditures were already planned – including the reconstruction project in Sichuan – and some were made but do not appear as such – including for example infrastructure investments made by state-owned firms)<sup>6</sup>, it was significant. In comparison with the size of the national economy, this package is larger than the US stimulus measures at the time. Most of this investment was made in infrastructure construction and development, but a sizeable portion was also aimed at enhancing public welfare. The second batch of the fiscal stimulus in March 2009 in particular included RMB 400 billion of investment in low-rent housing and social welfare RMB 150 billion in public health-care, culture and education.

Thanks to the increase in fixed investment, China did not suffer a severe recession and the investment in public welfare may ultimately have a positive effect on domestic consumption. However, overinvestment can lead to overcapacity and non-performing loan problems. In general terms, investment is, like exports, a weakness for the economy if not balanced by domestic consumption.

## Domestic consumption

### *Low household spending*

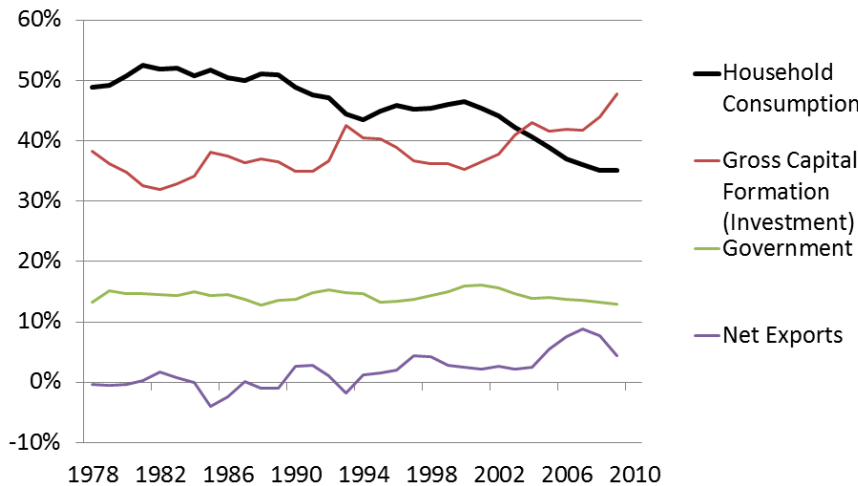
Along with exports, government investments are boosters of China's economic growth, but they are not balanced by domestic consumption. As the IMF pointed out in 2010, consumption in China is unusually low and has continued to decline as a share of GDP over the past decade. China's consumption share of GDP has fallen steadily since the era of economic reform. During the past decade, the decline has been even faster. Between 1997 and 2009, gross investment

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<sup>6</sup> See Françoise Nicolas, *The Global Economic Crisis: a Golden Opportunity for China*, "Asie Visions", June 2009, pp.14-15.

rose from 32 percent to 46 percent of GDP, while household consumption fell from 45 percent of GDP to 36 percent, amounting to \$1,773.3 billion.<sup>7</sup>

**Figure 2: Breakdown of China's GDP - Slowing Household Consumption<sup>8</sup>**



Source: CEIC: National Bureau of Statistics, March 2011.

China's consumption expressed as a share of GDP is lower than in most emerging countries: of the BRIC economies, China is the only one to have a consumption share of GDP drop below 45 percent. In Brazil for instance, the share is 64 percent.<sup>9</sup>

In historical comparison with the East Asian development models, marked by high levels of investment and low levels of household consumption, China's low household consumption share is also unprecedented. Household consumption fell during the early stage of development in Japan, South Korea or Taiwan, but never as low as China's current consumption in proportional terms. In each of the three economies, except in Taiwan for a short period of time in the late 1980s, the share of household consumption always remained above 50 percent of GDP. China's low levels of consumption are therefore unparalleled.

### *High household savings rate*

China's low level domestic consumption can be partly related to a high and rising savings rate in Chinese households. These households save on average almost 40 percent of their disposable income, according to the National Bureau of Statistics (2009). Several aca-

<sup>7</sup> IMF figures / Financial Times, *Wen is right to worry about China's growth*, Martin Wolf, September 21<sup>st</sup>, 2010.

<sup>8</sup> Data compiled by World Economic Roundtable. in "Putting China's Low Household Consumption in Perspective", March 2011.

<sup>9</sup> Consumption is given as a % of 2009 GDP (IMF).

demographic surveys based on different methodologies and sample coverage found a significantly lower figure (around 30 percent), but even with this result Chinese households appear as big savers. According to a recent survey conducted by Credit Suisse, who interviewed 13,000 households in seven emerging markets, China has the highest savings rate among emerging markets.<sup>10</sup> The Chinese households surveyed - from low to high disposable income, living in 10 different cities in China - were saving about 31 percent of their income, i.e. far more than Indian households (17 percent), Russian households (13 percent) or Brazilian households (10 percent) surveyed.

Chinese households not only save a large share of their disposable incomes, but their average savings rate has increased over the last 15 years.<sup>11</sup> Both National Bureau of Statistics and Urban and Rural household surveys show that the savings rate increased by about 10 percentage points during this period.

Of course, there exist substantial differences between a rural and an urban household's savings behavior, but in both areas household savings rates increased. This increase is particularly significant for urban households, for whom disposable incomes account for about two-thirds of national income and rose faster than rural income. But rural households also save a large share of their income since in rural areas many are without a state pension, state health care and other social benefits. In both rural and urban areas, the high savings rate is due to uncertainty over the provision of social benefits and the increasing costs of education and medical fees. In addition, Chinese households also save for life-cycle events such as wedding celebrations, an important factor in their saving decisions.

### *Transition stage*

The above facts show that China's economy is still currently relying heavily on exports and government investments, much more than on domestic consumption. This situation represents a double weakness, both in the immediate and in the longer term. China's economy needs to readjust in order to limit its current dependence on investment and exports, especially as labor costs are rising. Most of all, it needs to readjust to ensure sustainable growth. In order to do so, China needs to reduce net exports and fixed investment as a share of GDP by boosting the share of consumption. Stimulating domestic consumption does not translate into a need to abandon the export-led growth strategy but rather to limit this dependency by rebalancing sources of growth.

China is well aware of these needs. Recent analyses from official think tanks, such as the Chinese Academy of Social Sciences

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<sup>10</sup> Credit Suisse Emerging Consumer Survey 2011, January 2011.

<sup>11</sup> For further details, see Chamon, M., Liu, K. and Prasad E. (2011), "Income Uncertainty and Household Savings in China", NBER Working Paper 16565, January.

(CASS), who lately released its “Annual Report of China’s Commercial Sector 2011”,<sup>12</sup> call for a substantial restructuring of the Chinese economy with a focus on boosting domestic consumption. Beijing knows that growth dependent on infrastructure investment and export is not sustainable, and that there is a strong need to develop domestic sources of growth, particularly consumption.

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<sup>12</sup> 商业蓝皮书—中国商业发展报告 - Annual Report of China's Commercial Sector 2011, CASS's Institute of Finance and Trade Economics, June 2011.

# Stimulating Chinese households' consumption

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## *Opportunities*

### **International perspective**

The size of the market, the state of transition, and the development of consumer society are often mentioned to underline the high growth potential of the Chinese domestic market. Household behaviors and demographic figures also show that Chinese households could consume much more than they do now, and that the context is favorable for such a development.

Regarding household consumption, optimistic forecasts can be drawn from an international comparative perspective. In Japan, South Korea and Taiwan, household consumption fell during the early stage of development - as it is still currently the case in China - but consumption eventually rose with economic restructuring. Over the last two decades, household consumption in Japan, South Korea and Taiwan increased sharply, gaining on average 10 percentage points of GDP.

In addition, the global economic crisis can be seen by optimists as an opportunity for restructuring. To some extent, the economic downturn pointed out the weakness of the export-led growth model. The damages done to the southern region – factories closing down, migrant workers fired, having to go back to villages, etc.. – were well-reported domestically and by foreign media, and remain in the government and public opinion's memory. Beijing has evidence for the immediate need to move ahead with a new, better balanced and more sustainable growth model. Following the crisis, it is even more aware that consumption boosted mainly by government stimulus can only keep the economy afloat temporarily.

### **Local perspective**

At an individual household level, the context looks favorable too. Rural households in particular represent a vast population of future consumers. According to the National Bureau of Statistics, China has

about 800 million rural citizens, and their income is currently low (the rural per capita net income was estimated at RMB 5,919 by the Chinese authorities in 2010, about ¼ of the urban per capita net income). Some in China argue, including the government, that urbanization - expected to increase to 51.5 percent by 2015 from the current 47.5 percent - as well as modernization of agriculture is likely to provide better living conditions for the population and turn farmers into consumers.

Beyond demography, consumer sentiment may also show that the context is favorable for the development of household consumption: in both rural and urban areas, consumer sentiments toward the economy tend to be generally positive. With a continuous release of economic growth figures approaching 10 percent, and large media coverage on China becoming the second greatest global economic power, most Chinese consumers believe in the country's economic development and are optimistic about it, even if they are yet to see any change within their own household. In general terms, confidence in economic growth is high among the Chinese population. The recent survey conducted by Credit Suisse concluded that *"the outlook from the Chinese consumer is optimistic. Confidence in improved immediate prospects for his/her financial position underpins very positive purchasing intentions."*<sup>13</sup> Consumer sentiments are known to powerfully influence the economy, and the Chinese population's confidence may point to a favorable context for the development of household consumption.

## **Major obstacles**

Although the context can be seen as favorable, there are nevertheless major obstacles to an increase in Chinese household's consumption. The most significant is the lack of an effective social safety net, which leads households to save in case of future hardships. Low income and inflation also represent significant obstacles to households' consumption. Household savings is not the only driver of high savings in China, government and corporate savings are also contributing parts. However, understanding major factors of high household savings and low consumption is important to identifying measures that would contribute to an initial increase in domestic consumption.

### **Lack of an effective social safety net**

The lack of an effective social safety net is traditionally said to be the main driver of household savings in China. The inadequate social

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<sup>13</sup> Credit Suisse China Consumer Survey 2011, January 17, p.7. Survey conducted among 2,585 consumers in ten Chinese cities.

protection system, combined with rising costs (healthcare costs especially, but also education costs), leads households to accumulate high precautionary savings. Most Chinese consumers know that they have to save a significant sum of money to ensure the future needs of one or several members of their family, but do not know exactly how much they need to save. Thus they tend to save as much as possible "in case" unavoidable expenses end up being high. Interviews within households suggest that healthcare expenses are a major – if not the main - fear for households and also their main reason for savings: *"We can plan future expenses such as tuition fees for the university of our child, his wedding ceremony in few years, but we don't know if someone from the family will fall sick at some point, if we will have to pay expensive surgery the day after or in ten years time."*<sup>14</sup>

Healthcare insurance is not widespread in China. Progress is being made to improve China's rural healthcare system, including a move towards universal coverage for rural areas, but a number of challenges still remain. If a growing number of Chinese citizens have access to healthcare insurance, the majority of them still have to pay medical fees first before being reimbursed. Moreover, strong inequalities still exist in China's healthcare system, as urban and rural coverage schemes differ.

To be sure, anticipation of healthcare costs is a major motive for the majority of Chinese households – urban and rural - when deciding to save. In general terms, weak government support for medical care, education, pensions, housing, but also fear of unemployment (with ineffective state worker protection, notably poor compensation benefits for workers who have been laid off) make Chinese households plan well ahead for future fixed and variable expenses. Combined with the lack of an effective social protection scheme, limited public services represent another factor contributing to high savings. Both the social safety net and public services need to be made much more comprehensive and effective in order to reduce household savings.

### Low household income

Low disposable income naturally has a negative impact on consumption. To some analysts, the falling share of household income in national income is the major cause of the declining share of consumption, above the rise of household savings rates.<sup>15</sup>

In late 2008, revenues dropped under the effect of the global economic crisis, and as a result, private consumption temporarily

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<sup>14</sup> Beijing household, working father, SOE cadre, 5 years to retirement, one child at university, two parents at home. Phone interview, June 2011.

<sup>15</sup> See for instance IMF economists Jahangir Aziz and Li Cui, in *"Explaining China's Low Consumption: The neglected role of Household Income"*, IMF Working Paper 07/181, July 2007.



slowed down. According to official figures (2010), the average per capita disposable income is RMB 19,109 in urban areas and RMB 5,919 in rural areas. In comparison with these levels of income, manufactured and imported goods appear very expensive, as does real estate. For instance, a Chinese consumer has to spend about 100,000 yuan for a small car and about 1 million yuan to buy an apartment in a mid-size city. Electronic goods are about the same price as in developed Western European countries for instance, although the average income level is 5 to 10 times lower in China. For rural income, food prices are expensive and often absorb more than a third of their disposable income.

Along with low disposable income, unemployment is another major issue when considering household consumption. It is hard to measure unemployment in China as many jobs are not declared. Officially, the unemployment rate appears low, under 5 percent, but migrant labor is not taken into account by the official rate of unemployment. What is clearer is that the global economic crisis has had a serious effect on unemployment in the factory region in the South, in and around Guangdong province. The government and independent local analysts roughly estimated that about 20 million migrant workers were unemployed in late 2008. This not only had a negative effect on migrant workers' living conditions but also impacted their extended families living at home in villages, as they were accustomed to receiving remittances. Many migrant workers found new jobs as China recovered from the global economic downturn and exports rose, but their situation remains precarious.

In addition to migrant workers, university graduates also face unemployment. Many of them do not manage to find a job in the months following graduation unless they are underpaid, and most university graduates are logically not willing to receive the same salary as non-educated workers - especially considering that their parents had made long-term sacrifices to pay for their education and hoped for white-collar positions for their only child.

National and international statistics assess that there are currently between 100 and 150 million workers either unemployed or underemployed in China. In general terms, incomes must rise, and unemployment and underemployment must be reduced in order to boost consumption. In some areas and industries, especially in the many factories of the Southern provinces, incomes have started to rise. But a much sharper increase in wage growth is needed to ease the constraints on household income.

## **Inflation**

In addition to low disposable income, inflation also prevents households from consuming more. Inflationary pressure has been strong in China during the last two years. The Consumer Price Index (CPI), a main gauge of inflation, reached 5.4 percent in March 2011 (year on year), its highest level since July 2008, according to the National

Bureau of Statistics. Even with repeated government measures to control inflation (reserve hikes, rise of the benchmark interest rates four times since last October), the CPI significantly increased in 2010-beginning of 2011.

Inflation first of all concerns food items, a major expenditure for low income households: food prices rose at a 12 percent annual rate. But inflation extends to non-food items as well: housing prices jumped 6.5 percent in April from a year earlier, the statistics bureau reported in early May 2011. Many urban high-income households invest in property, making prices rise. But low and mid-income Chinese household's cannot afford housing and are saving extensively to be able to do so one day - in a country where property ownership is a social obligation. Rents themselves have sharply risen (6.5 percent during the first quarter of 2011, according to the National Bureau of Statistics). In addition, high prices also affect imported goods. The weak currency boosts exports but also reduces household purchasing power by making imports expensive.

Some analysts argue that the fear of inflation in China is exaggerated; that the situation is more stable than in 2007-2008, during which food prices reached extremely high levels.<sup>16</sup> But officials from the National Development and Reform Commission (NDRC) warned recently, in April 2011, that the consumer prices may stay high for the rest of the year under increasing inflation pressure. In April 2011, the Chinese Academy of Social Sciences (CASS) issued a blue book in which it recommends that the government take strong measures to tame inflation. The Chinese government is well-aware of this issue. Inflation is "*the most pressing problem*" facing the world's second-biggest economy, Vice Premier Wang Qishan said in early May. It surely represents a major obstacle to consumption as it affects household purchasing power and consumer confidence.

### Other obstacles

In addition to the major obstacles discussed above, other factors are contributing to low domestic consumption, such as underdevelopment of consumer finance, population aging or intergenerational consumption.

Very few formal consumer credit mechanisms are available in China to facilitate households' desires to shift consumption from the future to the present. Underdevelopment of consumer finance makes it difficult to borrow against future income. There is a need for alternative sources of funding for firms, and alternative investment opportunities are also required for households. Consumer finance is starting to develop in China but much remains to be done in the field.

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<sup>16</sup> *The Economist*, "Inflated fears", Jan 6<sup>th</sup> 2011.

Regarding the aging of the population, it can be said that it is a growing factor of high savings. The typical trend is that savings rates increase with the age of the head of the household, peaking prior to his retirement, and then turns negative in retirement. Prasad, Liu and Chamon also observed that motives for saving in China vary significantly according to the age of household members: rising income uncertainty and housing purchases motivate savings for households with young head of household while pension reforms and rising medical expenditure explains much of the rise in the saving rates of households with older heads.<sup>17</sup> The last national census, conducted at the end of 2010, reveals population aging, with an increase of 2.93 percent in the share of Chinese over age 60, as compared to the last census in 2000. At the same time, the share of those under 15 dropped 6.3 percent. With the aging of the population, precautionary savings for anticipated health care and dependence costs are likely to increase. This is particularly true in China, as state pensions are low.

Finally, intergenerational consumption has to be considered in order to understand the Chinese household's savings and consumption behavior. Most Chinese consumers anticipate expenses according to their own needs but also to the needs of other members of their family. Parents anticipate expenditures related to their child's education, health, wedding and moving house. Children anticipate expenditures related to their parent's retirement, health, lodging and other needs (food, leisure, etc.). As interviews with Chinese consumers reveal, savings are estimated according to the anticipated needs of the next generations: "*We are currently saving for our daughter, who is still studying and is needing our help, she is doing well, as her husband is a manager, but who knows... and now we are also saving for the future of our grandchild, just born, who might need our help later, when it will be time to pay for his education.*"<sup>18</sup> Intergenerational consumption originates from traditional Confucian values, but is perpetuated by the lack of an effective social safety net: family solidarity compensates for the absence of a welfare state. Some financial individualism and independence is showing up in a few urban families, but the vast majority of Chinese households are still practicing strong intergenerational solidarity. This practice influences savings behavior: instead of consuming for himself, the Chinese consumer will tend to save 'in case' a member of his family needs it in the future.

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<sup>17</sup> K., Chamon, M., *The puzzle of China's rising household saving rate*, VoxEU.org, January 18th, 2011.

<sup>18</sup> 51 year old mother, married, working, annual household revenue > RMB 100 000, Chengdu, Sichuan. Phone Interview, May 2011.

## A government priority

The Chinese Government is well-aware of the need to reduce the economy's reliance on exports and investment and to stimulate domestic consumption, and has been for several years now: the 11th Five-Year Plan already mentioned the restructuring as one of its major policy directions. Since 2003 the government has been trying to promote consumption growth. The global economic crisis made self-evident that the economy's reliance on exports was a weakness, and this may have to some extent sustained, if not reinforced, the government's will to accelerate the economic transition: "*enlarging domestic demand*" was one of the official objectives of the stimulus package presented by Prime Minister Wen at the end of 2008 and beginning of 2009.

In addition to the fiscal stimulus package, the Chinese government took a number of measures to improve the healthcare system, and to allocate subsidies for the purchase of consumption goods. These subsidies were especially designed to boost domestic consumption, especially in rural areas. For instance, the government initiated campaigns such as "家电下乡" (*jia dian xia xiang*), a rebate scheme to encourage rural residents to buy electrical home appliances. The Chinese government also offered farmers a grant to upgrade farm vehicles to light trucks and cars. The 12<sup>th</sup> Five-Year Plan is in line with all these previous measures, emphasizing the need to develop domestic demand.

## The 12<sup>th</sup> Five-Year Plan

### *Planned restructuring*

Restructuring the economy is one of the key objectives of the 12<sup>th</sup> Five-Year Plan, along with industrial upgrading. The plan clearly mentions that increasing domestic consumption is one of the major economic restructuring targets.<sup>19</sup> The aim is clear from the first pages: one of the four policy directions is to establish a long-term mechanism of expanding domestic demand. In order to '*create a positive consumption environment*', the plan is focusing on four points of development: urbanization, employment, distribution reform and the social security system. The final aim is to 'gradually make the

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<sup>19</sup> 中华人民共和国国家经济社会发展十二五计划 (*zhong hua ren min gong he guo guo jia jing ji she hui fa zhan shi er wu ji hua*), *The Twelfth Five-Year Plan for National Economic and Social Development of The People's Republic of China*, Approved by National People's Congress, March 14, 2011.

overall size of our domestic market rank among the largest internationally'.<sup>20</sup>

Promoting urbanization is by far the most developed policy line of the Chinese government to stimulate domestic consumption. The plan extensively presents detailed measures to accelerate urbanization (including a strategic layout, a list of target cities for capacity enlargement, etc.).<sup>21</sup> Since the release of the plan, government representatives and think tanks widely underline that urbanization is an engine of domestic consumption growth.<sup>22</sup>

In addition to urbanization, the plan focuses on the reinforcement of the social safety net, in line with the social insurance law, released in late 2008, that established a common right for all citizens to social insurance for unemployment, medical care, work injuries and childbirth. The plan goes much further than the 2008-2010 measures, especially in the field of health care, with the announcement of new construction of medical service network in both urban and rural areas, and further information on the reform of public hospitals, on the training of general medical practitioners, on the guarantee system for the supply of basic drugs, among other developments.

Regarding household living standards, an entire part of the plan is dedicated to improving people's well-being. Measures to improve people's living conditions are numerous and well-targeted (cf. Table 1). They relate, in addition to healthcare, to housing, pension coverage as well as employment protection.

Raising rural living standards in particular is a well-emphasized policy direction of the plan. One of the major initiatives is to create 45 million urban jobs over the next five years and reduce the number of people living in poverty. The final aim is to improve the lives of low and mid-income households, especially in Western/interior rural areas (750 million farmers in more than 400,000 villages) and eventually turn them into consumers. Another measure underlines the need to construct affordable housing: the objective is to construct 36 million units of social housing in 2011-15, to give access to 20 percent of urban households by 2015, compared to about 7 percent now.<sup>23</sup>

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<sup>20</sup> *Op. cit.*, Chapter 4: Policy Direction.

<sup>21</sup> *Op. cit.*, Chapter 20: Actively and steadily promote urbanization

<sup>22</sup> Xinhua, "China to prioritize domestic consumer demand", March 21, 2011 / China Daily, "Lu explodes myths of China's growth", January 7, 2010, "As industrialization and urbanization both speed up and more residential units are sold, domestic demand will push economic growth in the future (...) as the urbanization drive expedites, Chinese consumers will spend more and their demand will make economic growth sustainable well into the next decade" reckons Lu Zhongyuan, vice president and senior researcher of the Development Research Center of the State Council.

<sup>23</sup> 中华人民共和国国家经济社会发展十二五计划 (*zhong hua ren min gong he guo guo jia jing ji she hui fa zhan shi er wu ji hua*), *The Twelfth Five-Year Plan for National Economic and Social Development of The People's Republic of China*,

The government also pledges to push the economy away from massive investment in heavy industries and enormous but cheap labor. Beijing is aware that wages need to be higher and unemployment reduced. To that aim, the 12th Five-Year Plan focuses on the development of new strategic industries, targeting their value-added output to account for 8 percent of the country's GDP by 2015. Developing the service sector appears as a major objective of the plan to stimulate employment and increase income levels. In general terms, the Chinese government, eager to attenuate risks of social unrest, is showing a commitment to reduce unemployment and increase salaries, and in general terms to stimulate domestic demand.

**Table 1: "People's well-being" targets, 12<sup>th</sup> Five-Year Plan**

<b>TARGET - People's well-being</b>	<b>2010</b>	<b>2015</b>	<b>Change over 5 years</b>	<b>Forecast or Binding</b>
Urban per capita disposable income (yuan)	19,109	26,810	>7%	expected
Rural per capita net income (yuan)	5,919	8,310	>7%	expected
Registered urban unemployment rate	4.1%	<5%		expected
New urban jobs			45 million	expected
Urban participants in basic pension insurance (hundred million)	2.57	3.57	1	binding
Participation in the basic medical insurance system for working and nonworking urban residents and the new rural cooperative medical care system			3%	binding
Low-income housing			36 million	binding
Overall population (billion)	1.341	<1.39	<0.72%	binding
Life expectancy			+ 1 year	expected

**N.B.:** "People's well-being" targets copied only ("Economic development", "Science and Education", "Energy and Environment" targets not copied).

Source: 中华人民共和国国家经济社会发展十二五计划 (zhong hua ren min gong he guo guo jia jing ji she hui fa zhan shi er wu ji hua), The Twelfth Five-Year Plan for National Economic and Social Development of The People's Republic of China, March 14, 2011 - Part I: Transforming growth pattern, create a new scenario for scientific development, Chapter 3: main targets.

However, the plan does not fully address the issue of barriers to labor mobility. The household registration system (hukou) remains

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Approved at the fourth session of the 11<sup>th</sup> National People's Congress, March 14, 2011, Chapter 35, Part VIII: Improve people's wellbeing, establish and improve basic public service system.

in place, although with some flexibility - the plan proposes to relax the barriers for rural migrants to obtain an urban hukou in small and medium-size towns. Moreover, the current system by which rural pension and health insurance schemes are separated from the urban counterparts remains in place, which will maintain an additional barrier to labor mobility. A removal of the barriers to labor mobility could have positive effects on income levels for nonurban natives.

In all, with the exception of labor mobility, most of the obstacles to an increase in household consumption are well-addressed in the plan: lack of an effective social safety net, unemployment and low income. Taming inflation does not appear as the top priority for current macro regulations in the 12<sup>th</sup> Five-Year Plan, but Beijing regularly underlines the need to control it. The Chinese government insisted in an April 2011 declaration that keeping the price levels basically stable was the primary and most urgent task for the government's macro-economic control this year. It recently took several steps to contain inflation, especially on food products (releasing grain from China's large reserves, increased subsidies to farmers, exemption from road tolls for vehicles transporting vegetables, boosting food imports, etc.).

# Towards higher household consumption?

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## *Right direction*

An analysis of the 12<sup>th</sup> Five-Year Plan reveals continued reliance on investment to support growth. For instance, investment in public housing is substantial. This investment will have positive effects on household living conditions, in contrast to the huge infrastructure investments the Chinese government generated in the past, but it shows no radical change away from the investment-led growth path. In that sense, the global economic crisis does not seem to be a turning point in China's economic restructuring.

However, the analysis of the new plan suggests that the rebalancing of the Chinese economy towards more domestic demand and less reliance on exports and fixed investments is well on track. During the 11th Five Year Plan period, some modest progress was made with rebalancing towards more services and domestic consumption.<sup>24</sup> The period of the 12<sup>th</sup> Five Year Plan will likely reveal more substantial progress. The Plan's content and related governmental declarations<sup>25</sup> show that the development of domestic demand is a priority of the next five years for Beijing. Most of the policy directions are coherent with current household needs, especially the improvement of the health care system.

Growing efforts to facilitate access to health care represent a first, but positive step to decreasing household savings. The new health reform developments should have more impact on consumption than past efforts initiated along with the 11<sup>th</sup> Five-Year Plan, as it is more comprehensive and takes better into account the needs of the rural population. According to Barnett and Brooks from the IMF, the sizable increase in government spending on health already had a

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<sup>24</sup> World Bank, *China Quarterly Update*, Beijing, April 2011, p.15

<sup>25</sup> "China will strive to establish a long-term mechanism to boost domestic consumer demand in the next five years", Zhang Ping, minister of the National Development and Reform Commission (NDRC) to Xinhua News Agency, "China to prioritize domestic consumer demand", March 21, 2011



large impact on household behavior.<sup>26</sup> The authors assessed that a one yuan increase in government health spending is associated with a two yuan increase in urban household consumption. They conclude that “*higher government health spending reduces urban household saving and suggests that broadening coverage of public health care could have an important effect on household precautionary savings.*” For rural households, Barnett and Brooks found no evidence of a relationship between government health spending and savings at the time of their analysis, as general government health spending supports urban insurance schemes whose members are disproportionately from higher income groups, even within urban areas. But the new health reform strategy aimed at providing universal coverage to poorer rural areas and increasing efficiency in the delivery of public health care may improve health outcomes and impact household consumption behavior.

Education spending may also have a positive, but less significant impact as precautionary saving motives of Chinese households are higher for health than for education. Measures to encourage the development of the service sector are also encouraging. As Guo and N'Diaye point out, raising the share of employment in the services sector can generate tangible results to increase private consumption.<sup>27</sup>

## **Combined issues, complex responses**

### **Complexity**

Most responses to low domestic consumption are complex. For instance, increasing wages requires fiscal reforms (heavy indirect tax paid by enterprises has an impact on prices and wages), but also social reforms (the strict ban on independent labor unions tended to hold down wages until very recently), among other measures. Some IMF analysts consider that financial sector weaknesses, by restricting firms' access to bank financing for working capital, have played a major role in keeping wages low and on a declining trend.<sup>28</sup> In that case, increasing income levels is even more complex as it requires financial reforms. A financial reform may also help reduce household savings. According to some ADB analysts, an insufficiently developed financial system is one of the two main drivers – along with inade-

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<sup>26</sup> Barnett S. and Brooks R., China: Does Government Health and Education Spending Boost Consumption?, IMF Working Paper 10/16, January 2010, pp. 9-11.

<sup>27</sup> Guo K., N'Diaye P., “Determinants of China's Private Consumption: An International Perspective”, IMF Working Paper, 10/93, April 2010, p. 13.

<sup>28</sup> Explaining China's Low Consumption: The Neglected Role of Household Income, Jahangir Aziz and Li Cui, IMF Working Paper, 07/181, July 2007.

quate social protection - for high urban household savings in China.<sup>29</sup> They underlined that younger households lack access to credit and accumulate savings in order to purchase durable goods, and concluded that policies that develop financial markets enabling borrowing against future income appear among top priorities.

Responses to domestic obstacles are also complex also because some of these obstacles are inherent to growth. This is the case of inflation, which is hard to control. Measures taken by the Chinese government, such as multiple interest rate hikes,<sup>30</sup> raising bank reserve requirements, and letting the Yuan appreciate, have not been effective enough to control prices.<sup>31</sup> The NDRC assesses that high inflation is a result of excessive liquidity in the global market and rising international commodity prices. It is also the indirect consequence of fast economic growth and a fragile agricultural foundation. Inflation is generally widespread among emerging economies (Chinese statistics officials recently insisted that "*China's March inflation data was still lower than the 6.3 percent for Brazil and 9.5 percent for Russia.*")<sup>32</sup>

In addition to obstacles inherent to growth, it can be argued that the international context does not facilitate economic restructuring. If China is to remain a major exporter, it is also because it has a competitive advantage in low-end industries due to its cheap and large labor force. Wage increases in factories will progressively reduce this competitive advantage, but many international companies still have difficulties finding suitable alternatives to manufacturing in China.

## Priority management

The major difficulty of stimulating household consumption is that several causes have to be addressed simultaneously, even though they are of a very different nature and call for very different responses. For instance, reinforcement of the social safety net and an increase in incomes are both necessary to stimulate household consumption, but they require very different responses that must be undertaken individually. The combined answers to stimulate household consumption are even more complex to undertake as one answer can go counter to another. For instance, wage increases in China would have some positive effects on household consumption as wor-

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<sup>29</sup> Jha, S., Prasad, E., Terada-Hagiwara, A., "Saving in Asia and Issues for Rebalancing Growth", ADB Economics, Working Paper Series #162, Asian Development Bank, May 2009.

<sup>30</sup> The People's Bank of China announced the second interest rate hike this year on April 5. It was the fourth increase since the start of 2010.

<sup>31</sup> Wen Jiabao himself warned in April 2011 that inflation is like a tiger—once unleashed, it is "very hard to cage again."

<sup>32</sup> National Bureau of Statistics spokesperson Sheng Laiyun for Xinhua News Agency, April 15, 2011.

ker net disposable income is higher, but higher labor costs also push up production costs and drives inflation.

Boosting consumption is surely not a simple task as it is a matter of priority management, between immediate growth on one hand and long-term economic restructuring on the other hand. To achieve the economic restructuring goal itself, priority management is key to bypassing several, very diverse obstacles. However, prioritization does not appear clearly in the new plan, nor does it in recent government declarations. In order to stimulate domestic demand, numerous measures are engaged at the same level, although some are more complex and time consuming than others. For instance, industrial upgrading and innovation is another key objective of the plan. Finding the right balance between the two objectives – rise in domestic demand vs. industrial upgrading - might be difficult, especially as the hierarchy is not clear.

In addition to priority management issues, implementation and execution might also be difficult for some measures, such as the creation of a vast amount of affordable housing, as it requires smooth coordination between central and local governments, which has not been easy to achieve in the past, especially when financing is not clearly defined for each institution.

## ***A long-lasting process***

### **Step-by-step improvements**

The outcome of the healthcare reform should not be overstated, but its impact on household consumption will surely be substantial. To be sure, Chinese household savings will remain high in the coming years. The Chinese government's efforts in welfare are significant but will not be able to provide in the short term an effective safety net for all the members of such a large population, many of whom are still poor.

The 12<sup>th</sup> Five-Year Plan "People's well-being" targets for 2015 are ambitious (cf. Table 1). Yet at the same time, even if met, these targets will lead to progressive middle and long-term stimulation of domestic consumption – certainly not short-term. Rural per capita net income is targeted to reach RMB 8,310 by 2015, a 7 percent increase from 2010, but still much lower than targeted urban income (RMB 26,810). Urban participation in basic pension insurance is targeted to reach 100 million more participants within 5 years, i.e. 357 million people, which is an impressive figure but still significantly below the population's needs. 36 million low-income housing units are expected to be created by 2015, but households will surely continue to save a significant amount of money on housing as the cost of

apartments and rents continue to reach record-high levels, especially in big cities.

Control of inflation, like the reinforcement of the social safety net, is a long-term issue as well. The rise in resource costs, a driver of inflation, will continue in the near future. Wages will also continue to increase, and push up costs in the services sector, leading to inflation. So logically it will cause prices to continue to increase in China. It is likely that China will face inflation pressure for many years. Credit Suisse estimates that trend CPI inflation may rise to 4-5 percent over the next decade,<sup>33</sup> in sharp contrast with the past decade over which CPI inflation was at around 2 percent. Analyses of several local economists lead to similar or more pessimistic forecasts: CPI could rise to 5 percent, or even 6 percent for several years.<sup>34</sup> The World Bank expects total consumption (including government consumption) to grow 8 percent in 2011, the same figure as in 2010.<sup>35</sup> It also forecasts rising wages and employment, that should benefit household income, but inflation is likely to continue to reduce real income growth and consumer confidence.

In general terms, it will surely take time to construct a domestically driven, consumption based economy in China. A growth in consumption would not necessarily lead to a rebalancing of China's economy. Consumption has to grow as a share of GDP, and this is surely a long-term process. Some analysts forecast the end of the transition to higher consumption – a level of 60 percent of GDP - in about 30 years from now.<sup>36</sup> It is hard to forecast exact figures, but the present analysis shows that the rebalancing of China's economy is a mid to long-term process, requiring at least two decades for completion.

To be sure, advancing consumer culture among households will take time. Households are accustomed to anticipating risks and save in accordance. Even if at some point China's government manages to establish an effective social protection scheme, consumer mentalities may take time to adapt to the new situation and to spend as if there were no hardship to anticipate and save for. A welfare state cannot come to light overnight; similarly consumers cannot change their habits suddenly, especially when they never experienced any kind of welfare state or institutional support. Even after significant improvements of social welfare, Chinese consumer behavior might remain precautionary: consumers might still be cautious in

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<sup>33</sup> Credit Suisse, China consumer survey China Consumer Survey 2011, January 17, 2011, p. 37

<sup>34</sup> 凤凰周刊 (Phoenix Weekly), No.2011, May, 25, 2011.

<sup>35</sup> World Bank staff estimates, *China Quarterly*, World Bank Beijing Office, April 2011

<sup>36</sup> "If GDP grows by 6% per year and consumption outpaces overall growth by 2%, it won't be until 2038 that consumption reaches a level of 60% of GDP, near the level of India, Brazil, Japan, and Taiwan today", Samuel Sherraden, *Putting China's Low Household Consumption in Perspective*. World Economic Roundtable, March 15, 2011.

their spending because they do not yet trust or believe that the state will be supportive in time of hardship. Changes in saving habits presuppose that Chinese citizens express a high level of public trust, especially in the government's ability to develop an effective and reliable social safety net, which is not evident. Continuous inflation headlines, old-fashioned government rhetoric and corruption scandals have contributed to a relatively low level of public trust.

## Conclusion

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China's economic growth is currently fueled by high exports and investments. Private consumption is not only low but has dropped dramatically as a share of GDP in the past two decades. The global economic crisis has revealed the weaknesses of this imbalance but has not so far contributed to redesigning sources of growth. At the moment, the China's economy continues to rely heavily on exports and investments.

However, Beijing takes this imbalance into cautious consideration and, as the 12<sup>th</sup> Five-Year Plan indicates, restructuring of the economy is one of its major mid-term objectives. It has engaged in a series of reforms in a wide range of areas (healthcare, education, housing, employment, development of the service sector, improvement of rural living standards, etc.) in order to stimulate domestic consumption.

Some issues are only partly addressed - labor mobility in particular - and the plan's priorities are numerous, leading to potential priority management issues. But overall, the 12<sup>th</sup> Five-Year Plan takes into account most of the issues at the source of low domestic demand. The government is engaged in the right direction to achieve restructuring.

If stimulating household consumption itself will surely take time, especially in rural areas where poverty is widespread, it is not because of lack of government consideration and action but merely because the process itself is extremely complex and time-consuming.

It is complex because it implies a conjunction of several long-term reforms in areas as diverse as welfare, employment, inflation control, development of consumer finance. There is no unique means to rebalance growth away from reliance on exports and investment and towards consumption, and some of the reforms may be hard to coordinate and integrate with each other. Continuous adjustment through time will be needed.

It is time consuming because none of these changes can be fully completed in less than a decade. The rebalancing of the economy is not a short-term process. In addition to the time needed for measures to take effect, which may vary depending on the effectiveness of coordination and execution, time is also needed for households to change their own habits, which might take even longer.

Changes in household consumption will highly depend on the capacity of the government to increase the efficiency of health-care coverage, and in general terms, to improve the social safety net, especially in the poorer, rural areas. Wage increases and inflation control will also be key factors impacting consumption behaviors in China.

Considering the amount and the complexity of obstacles to the development of domestic consumption, the process is certainly a long-lasting one, even with strong governmental will and reactivity to upcoming economic challenges. The present analysis suggests that China's economy is likely to restructure in the middle and long run.

Provided the Chinese government keeps driving in the same direction – and there is no reason it would not do so – and that no major economic downturn occurs in the near future, it is very likely that Chinese household consumption will gradually but significantly increase during the next twenty years and that China's domestic market will eventually rank among the largest in the world, if not at the very top. China's economy will then achieve a more sustainable growth, fueled not only by exports and investments but also by domestic consumption.

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