# China's macro disconnect

By Stephen S. Roach
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Structural change and rebalancing are formidable undertakings for any economy. China has been focused on these objectives for five years – seeking to transform a powerful yet unbalanced growth model based largely on exports and investment into one driven increasingly by its consumers. Success is essential if China is to avoid the dreaded "middle-income trap" – the economic slowdown that most fast-growing developing economies experience when they reach income thresholds comparable to that of China today.

The results have been mixed. China has been highly successful in its initial efforts to shift the industrial structure of its economy from manufacturing to services, which have long been viewed as the foundation of modern consumer societies. But it has made far less progress in boosting private consumption. China now has no choice but to address this disconnect head on.

The performance of China's services sector has been especially impressive in recent years, with its share of GDP increasing from 44% in 2010 to 51.6% in the first three quarters of 2015, according to official statistics. That is nearly double the four-percentage-point increase that was initially envisioned in the 12th Five-Year Plan, which is about to come to an end.

The gains have been particularly strong in the distribution sectors – wholesale and retail trade – as well as in finance and real estate. And China's shift to services has only just begun. It should broaden into IT services, healthcare, domestic transportation, and hospitality and leisure, as the sector as a whole climbs toward a 60-65% share of GDP over the next decade.

By contrast, consumer-led growth has been much slower to materialize. After bottoming out at 36% of GDP in 2010, private consumption's share of GDP inched up to 38% in 2014 – a two-percentage-point increase that is only about one-fourth the magnitude of the services-led shift in the economy's structure.

With its prowess in central planning, China has always been adept at engineering shifts in its industrial structure – as the move toward services-led growth attests. But China apparently is far less proficient in replicating the DNA of a modern consumer culture – specifically, in altering the behavioral norms of its people.

The disconnect between surging services and lagging growth in private consumption has been accompanied by a steady rise in China's urban saving rate to 30% in 2014 (versus 24% a decade earlier). This has occurred despite a significant increase in the personal income share of the Chinese economy, driven by services-led employment growth and the income leverage of urbanization. Chinese families have been reluctant to convert much of this newfound income into discretionary spending.

China's high and rising urban saving rate in a climate of vigorous per capita income growth reflects a persistent preference for precautionary saving over discretionary consumption. Unfortunately, this is a rational response to the uncertain future faced by the majority of Chinese families, underscored by the lack of a reliable social safety net. Moreover, anxiety over inadequate provisions for retirement and health care is set to intensify as a rapidly aging population now enters the most vulnerable phase of its life cycle.

The good news is that the 13th Five-Year Plan (covering the 2016-2020 period), which is to be enacted in March 2016, appears likely to address these concerns explicitly. Early indications from the Fifth Plenum of the 18th Central Committee of the Communist Party of China, held in late October, suggest that the next plan will focus on the missing piece of consumer-led rebalancing: a strong social safety net.

A proposed consolidation of rural and urban plans for pensions and critical health care is particularly important in this regard, as is the authorities' commitment to allowing workers to transfer their hukou (residency permits) – and the associated social welfare benefits – wherever they move. For China's 270 million migrant workers, benefit portability could be decisive in shifting the balance from fear and precautionary saving to security and discretionary spending. Equally significant was the Fifth Plenum's emphasis on using state capital to fund a more robust safety net through an increase in taxes on state-owned enterprises that was proposed a couple of years ago.

But the biggest breakthrough in reshaping societal norms was in family-planning policy – replacing the one-child limit that had been in force since 1980 with a two-child limit beginning in 2017. Aimed at addressing China's serious aging problem, the eventual consequences of this long-overdue shift cannot be minimized. As the family unit, central to China's Confucian heritage, changes, so will the country's social and economic character.

Over the past 35 years, China's powerful growth model has yielded extraordinary progress in terms of economic growth and development. But speedy implementation of the shift from production to consumption will be vital if the country is to remain on course and avoid the middle-income trap. That will require resolving the disconnect between the structural shift to services and the behavioral norms that will ultimately shape the spending habits of its people.

And that means overcoming the understandable caution of Chinese households in the face of an uncertain future. Converting fear into confidence is a daunting task for any society. China is no exception. The focus on resolving China's macroeconomic disconnect, reflected at the Fifth Plenum and a likely precursor of what to expect in the upcoming 13th Five-Year Plan, is thus very encouraging.

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