

China Chartbook

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# Consumer Outlook & Thematic Review

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November 2014

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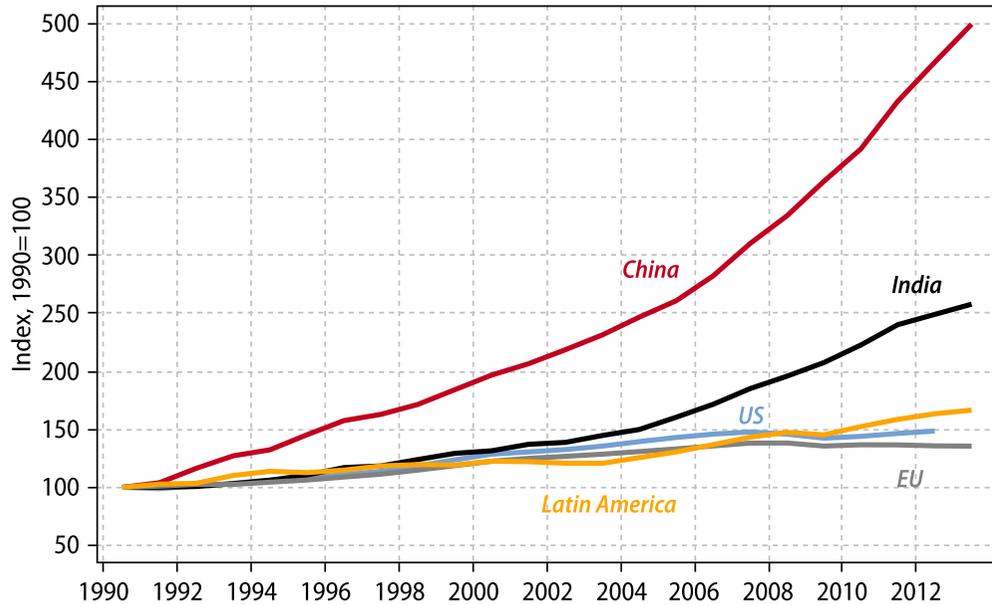
# Part 1

## The macro outlook for consumption

# The paradox of Chinese consumption

## China has had the fastest consumption growth of any major economy

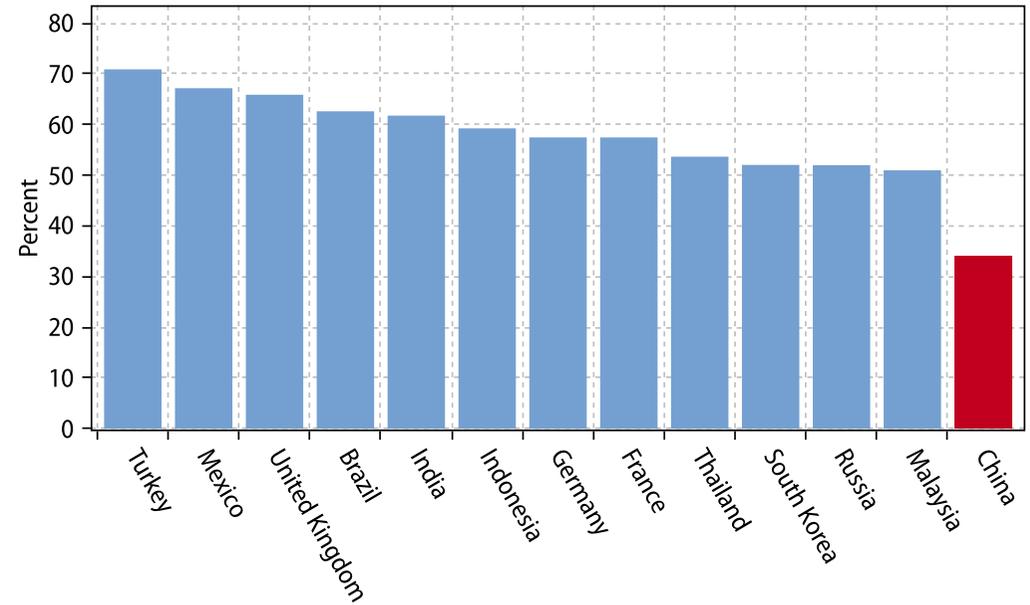
Per capita household consumption, in US\$ at constant prices



Gavekal Data/Macrobond

## Yet the share of household consumption in GDP is a global outlier

Household final consumption as a share of GDP, 2013



Gavekal Data/Macrobond

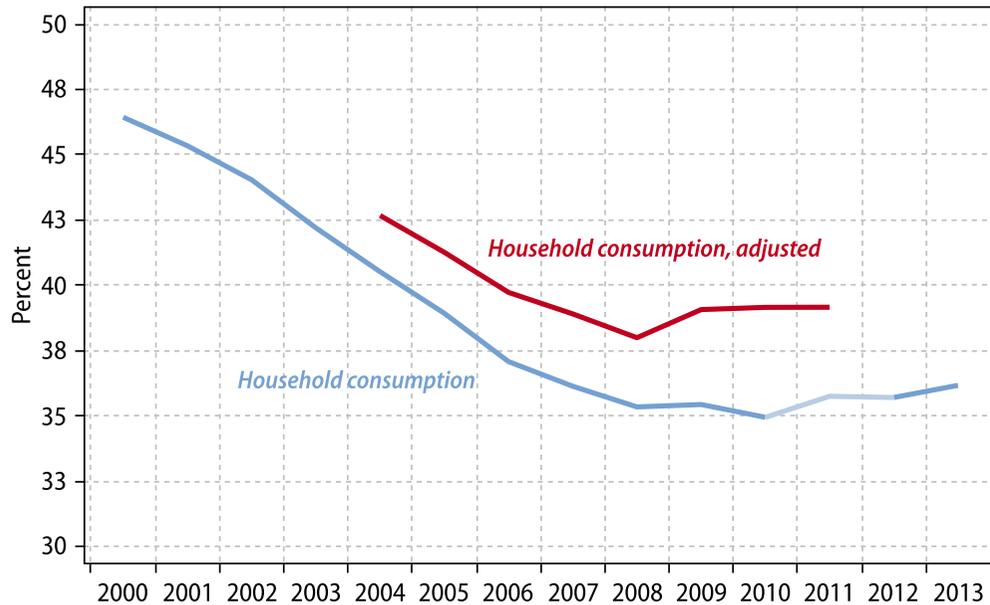
China has had the fastest growth in per-capita consumer spending of any major economy in the world over the past decade. Rather than taking money out of consumers' pockets, China's rapid, investment-driven growth enabled very fast growth in household incomes, which in turn led to rapid growth in consumption.

But because investment growth was so much faster than consumption growth, the share of China's household consumption in GDP is extremely low by global standards: 34%, when 50-60% is more common for major economies. This is not a sign that consumption is weak but that investment has been very strong.

# Household consumption is even larger than it appears

## China's household consumption is underestimated

Share of GDP, official versus own estimate

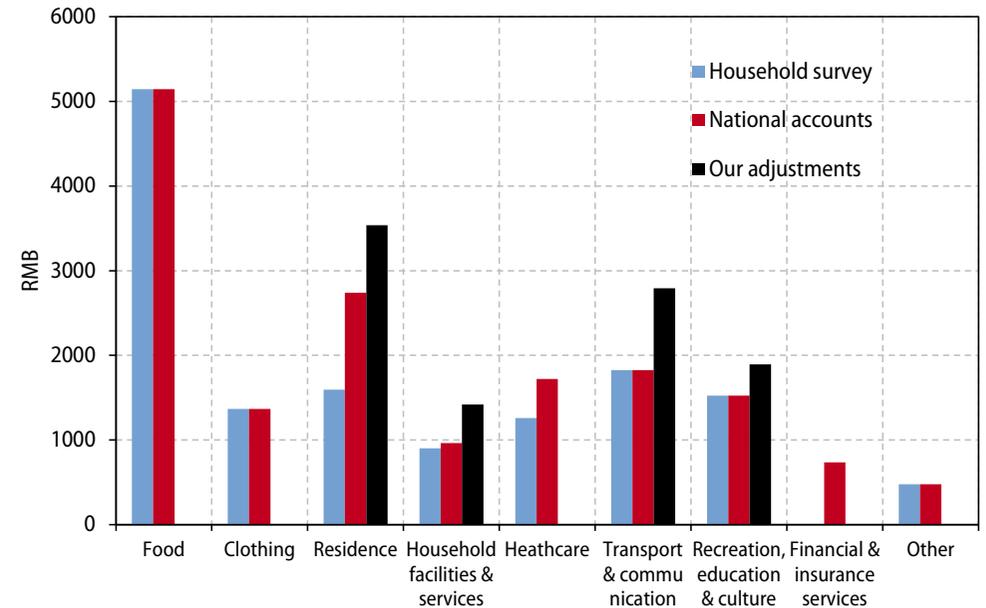


CEIC, Gavekal Data/Macrobond

We do think household consumption is likely underestimated in the national accounts, due to some weaknesses in methodology that fail to capture consumption of newly formed households and of some services, particularly housing. These issues plausibly account for 3-4 pp of GDP, which is significant but not enough to change the story of a low consumption share.

## The "missing" consumption is concentrated in a few areas

China's household consumption by category, 2011



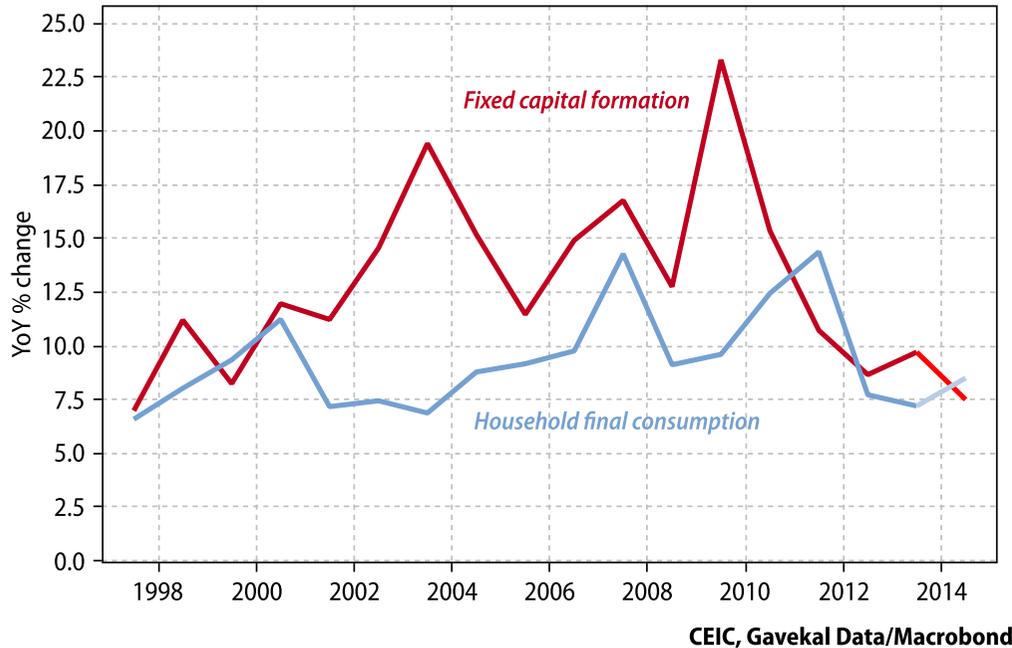
CEIC, Gavekal Dragonomics research

The problems with estimating consumption are focused in a few areas, which NBS appears to be aware of. Detailed data on household consumption have not been updated recently, as NBS is overhauling the household survey and updating the national accounts methodology. When figures under the new system are published, likely in 2015 or later, undercounting may become less of a problem.

# Consumption is slowing, but rebalancing is still happening

## Consumption has slowed, but not by as much as investment

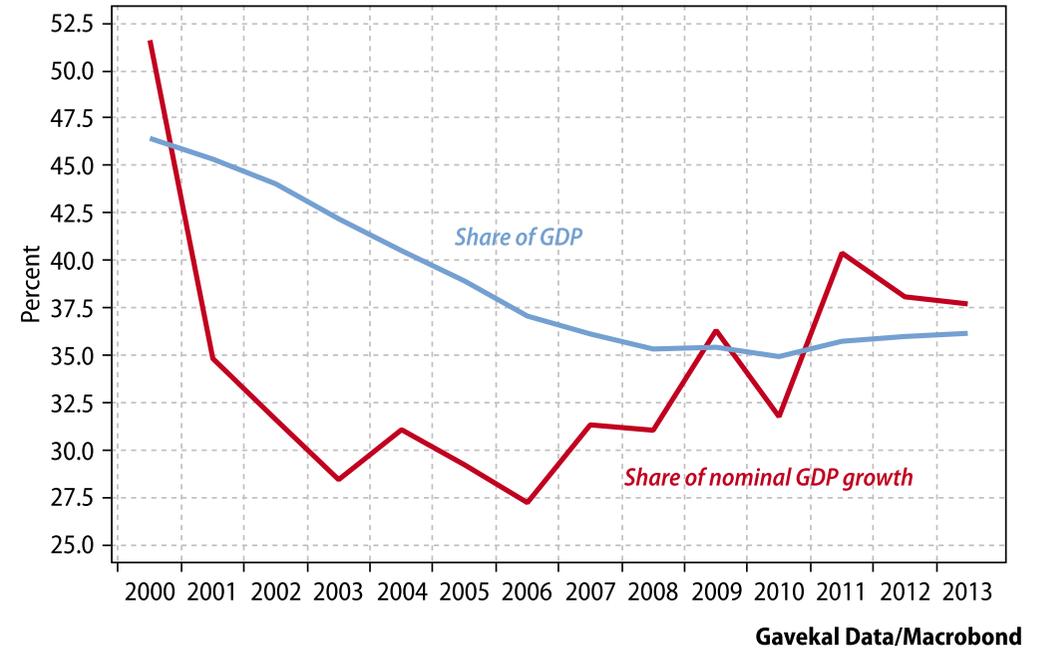
Estimated real growth of national accounts expenditure components



Investment growth has slowed down sharply since 2009, but household consumption growth, while also slowing, has been relatively resilient. We estimate fixed capital formation growth in real terms is now running at half of the previous decade's average of 15%. The real growth rate of household consumption has slowed to similar rates—around 7-8%—but the drop from the previous trend of 9% is less dramatic.

## A turn in China's consumption trend

Household final consumption expenditure's share of GDP and GDP growth

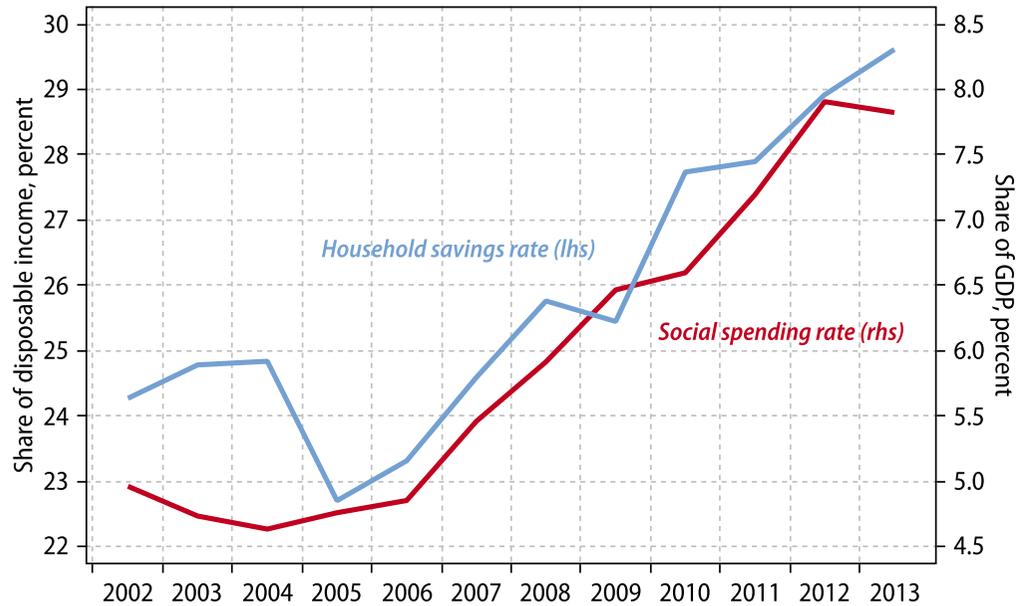


Consumption growth may not be accelerating, but the much-discussed “rebalancing” toward consumption has in fact begun: the share of consumption in GDP has increased, albeit marginally. The share of nominal GDP growth coming from consumption has risen more. With investment continuing to slow the share of consumption in both GDP and GDP growth is likely to rise more noticeably in coming years.

# High savings rates will decline only gradually

## China has built a safety net, but households are still big savers

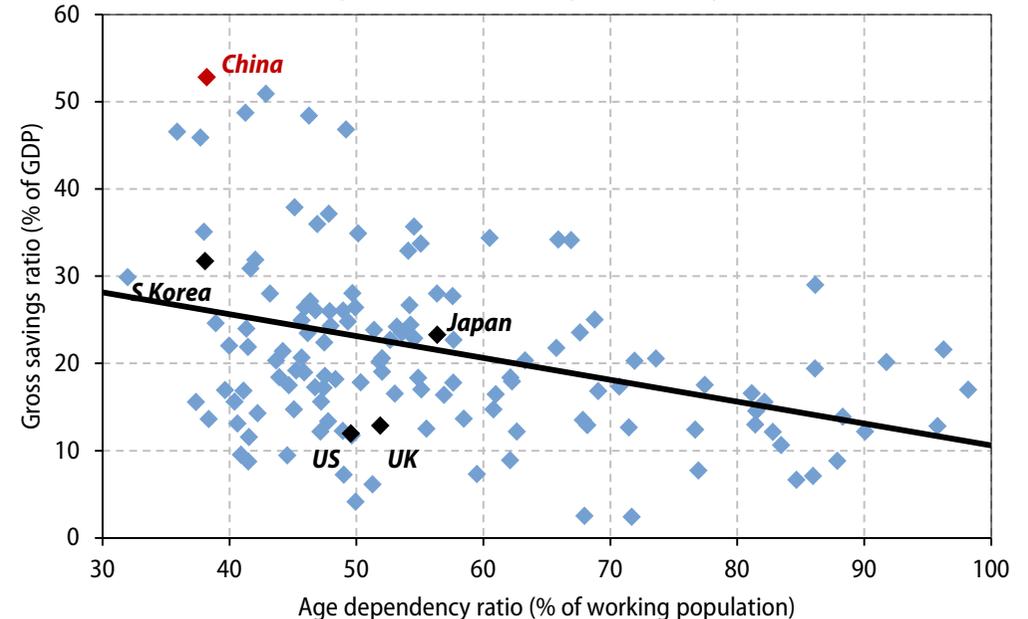
Households savings and government spending on health, education and social security



Gavekal Data/Macrobond

## China's saving rate should fall as the population ages

Gross savings ratio compared to age dependency ratio



World Bank, Gavekal Data

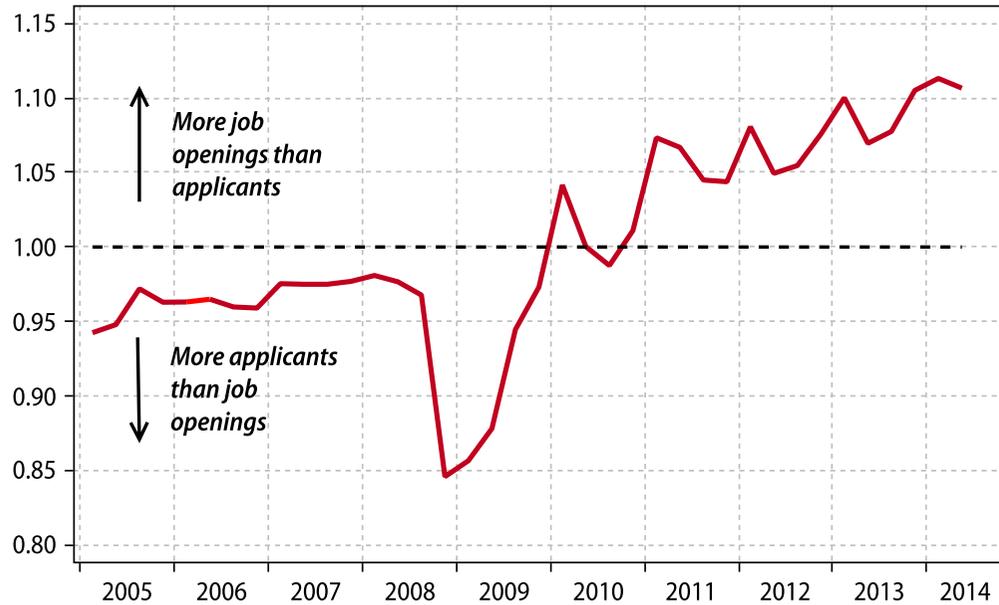
China's consumption growth is still driven primarily by income growth, with little sign of major changes in savings behavior. The household savings rate remains high and is still rising. Over the past decade, the household savings rate has not responded at all to the significant expansion of social welfare policies—including near-complete health insurance coverage. The "precautionary savings" hypothesis for why Chinese households save seems much less plausible these days.

We still expect China's savings rate to gradually decline over time, even if it's not because of a better social safety net. National savings rates tend to fall as the population ages: because workers tend to be net savers, while the young and the old tend to be net spenders, a rise in the dependency ratio often means a fall in the savings rate. Cultural shifts also mean the current generation of workers will likely have a higher propensity to spend than their parents did.

# Wage growth and financial assets support household incomes

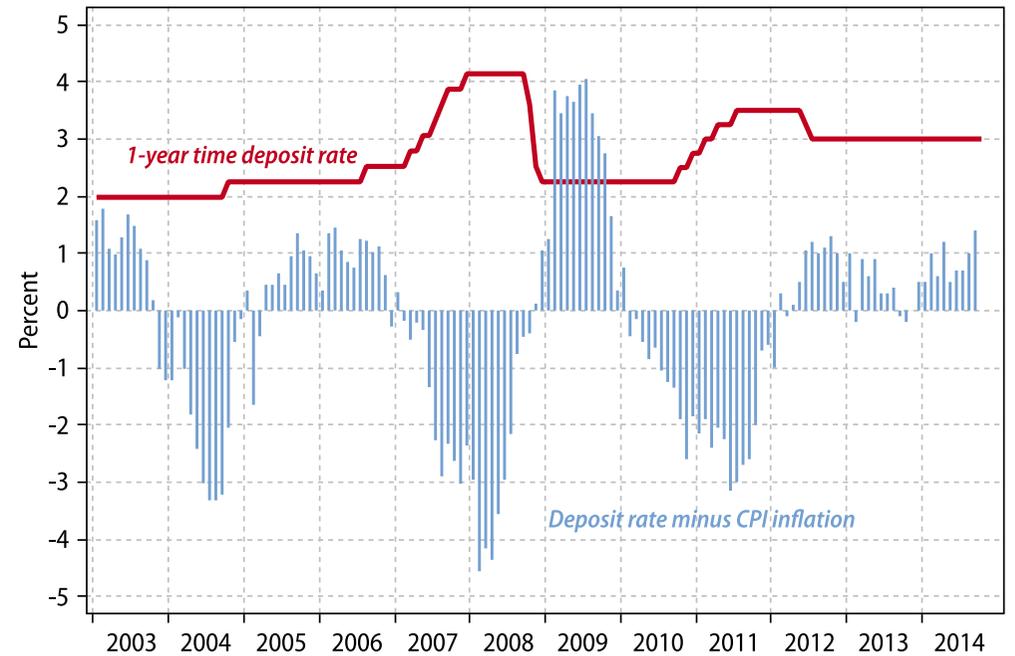
## China's job market is still tight, despite slowing growth

Ratio of labor demand to supply, from survey of urban job placement centers



Gavekal Data/Macrobond

## Deposit rates have been mostly positive in real terms since 2012



Gavekal Data/Macrobond

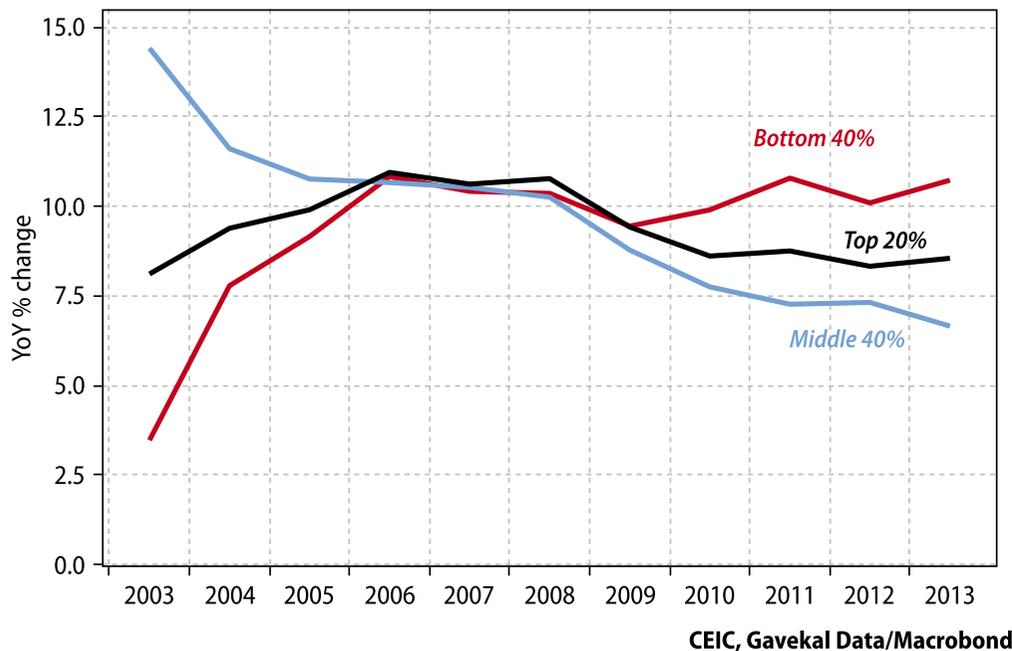
The resilience of consumption relative to investment ultimately comes from incomes. Though wage growth has slowed, a tight labor market means employers still have to keep raising wages. The supply of labor is growing more slowly than employers' demand for workers, due to demographics compressing the working-age population, and urbanization curbing the flow of rural migrants.

Households are also earning more real income from their financial assets, thanks to interest rates on bank deposits that are no longer consistently below inflation. Higher rates of return are increasingly available from money-market funds or wealth-management products. This is a result of a quiet change in monetary policy: inflation has come down significantly since 2012 but rates have not.

# Diminishing inequality offers limited help to consumption

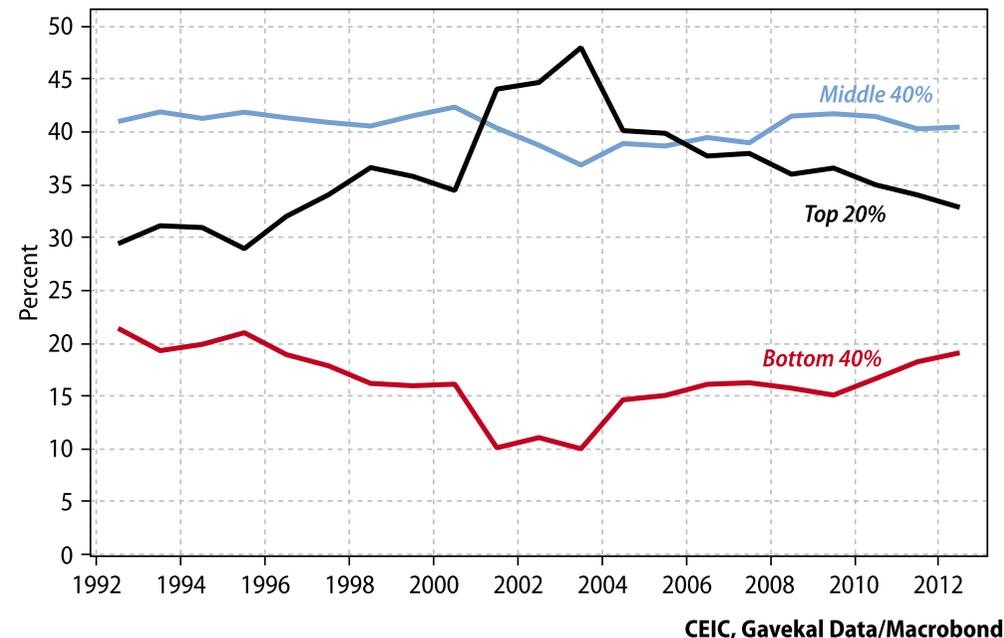
## China's lowest incomes are now rising the fastest

Real growth in urban household income, by quintiles, 3ycma



## Consumption is now more driven by middle and lower income groups

Contribution to nominal growth in urban consumption, 3ycma, by income group

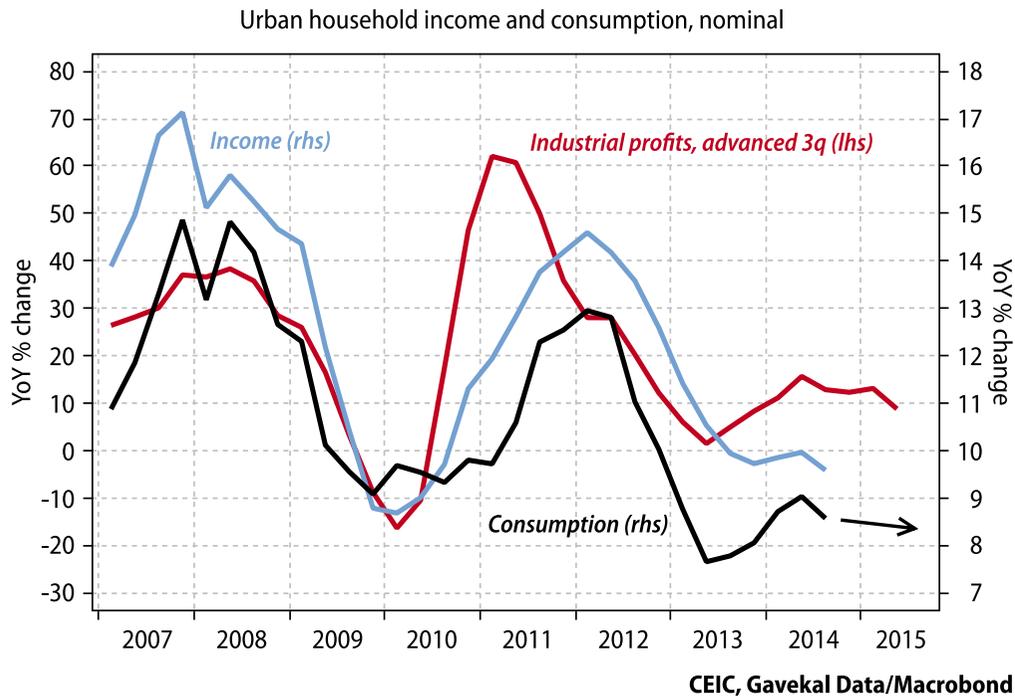


The changing dynamics of the labor market have offered the strongest support to blue-collar and lower-income workers, particularly rural migrants. The effect of the slowdown in economic growth since 2009 is more evident in the sluggish wage growth of the white-collar workers who occupy the middle and upper rungs in the income distribution. With wages of lower-income households now rising faster than higher-income ones, income inequality is actually narrowing.

Unfortunately this does not provide much support to *total* consumption growth: while the incomes of the bottom 40% are rising fast, they remain quite low. The biggest drivers of consumption growth are the middle classes, who have higher incomes than the bottom 40% and lower savings rates than the top 20%. The slide in their income growth helps explain the slowdown in total consumption growth since 2009, and is a reason to be cautious about future consumption growth.

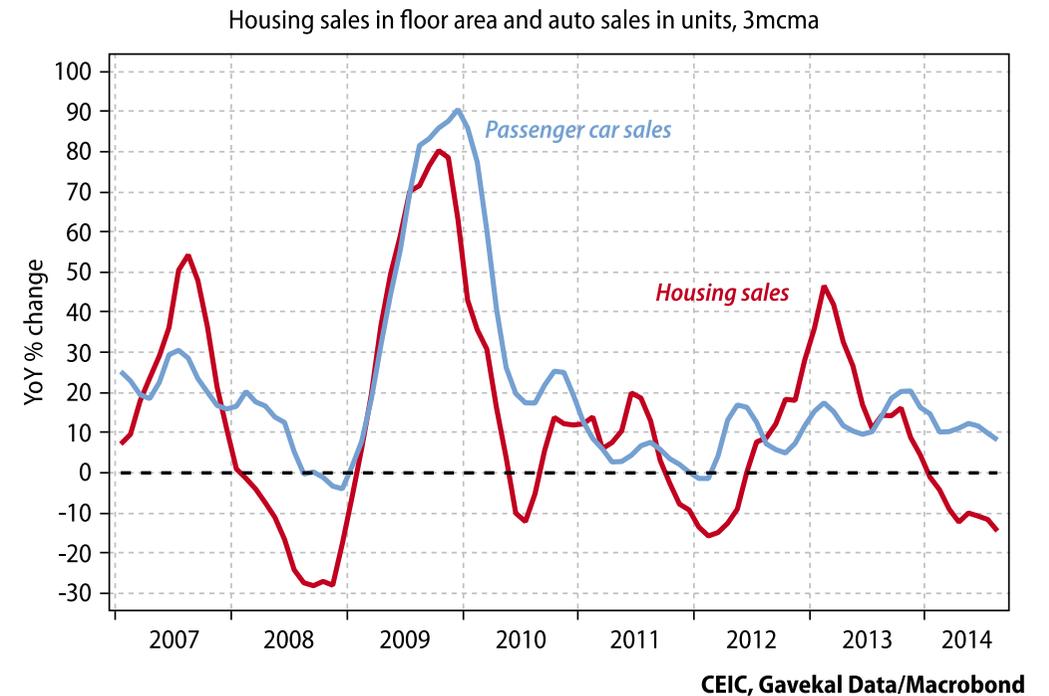
# The near-term outlook for consumption is not great

## Household consumption has been stable in 2014 but is slowing



While consumption is relatively resilient, consumers are not isolated from the rest of the economy, and consumption cannot boom when overall growth is also weak. Income and consumption tend to lag the corporate profit cycle. This makes sense as profitability affects how generous employers are in giving wage increases. Consumption growth held up well in the first half of 2014, but as profit growth has since turned down, consumption will be weaker in early 2015.

## With housing sales declining, car sales are likely to follow



The current downturn in the housing market is also not good news for major consumer goods, since many of these are often purchased in tandem with a new place to live. Housing sales and car sales have long been tightly correlated, a relationship that points to auto sales being relatively weak. But if car sales become more driven by people replacing their current car, rather than buying their first car, the trend may diverge from housing sales.

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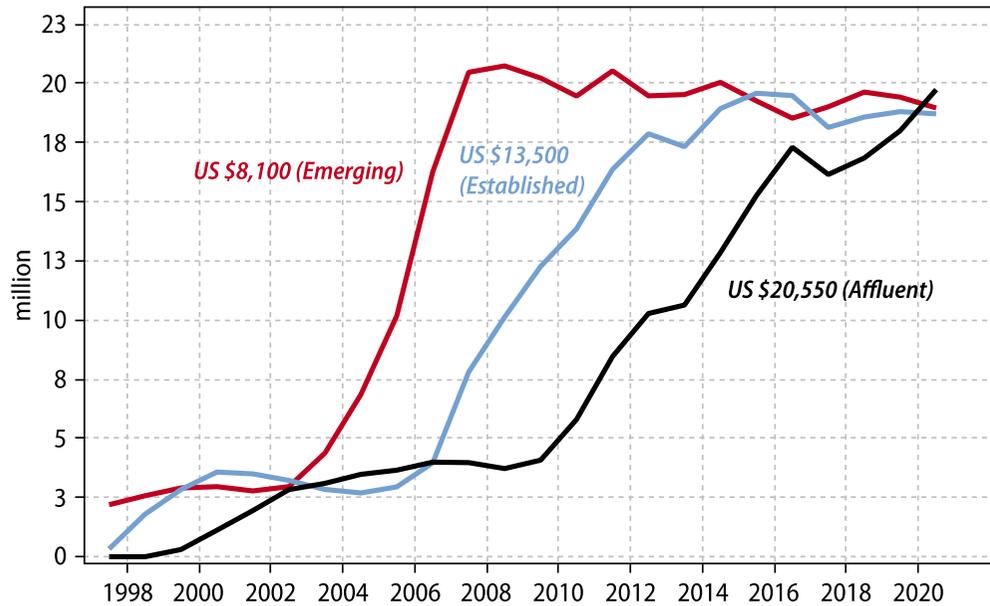
# Part 2

## Consumption themes

# More consumers are crossing over into higher income brackets

## Growth in affluent Chinese consumers is set to sharply accelerate

Total Chinese households crossing each income threshold in a year, 3ycma

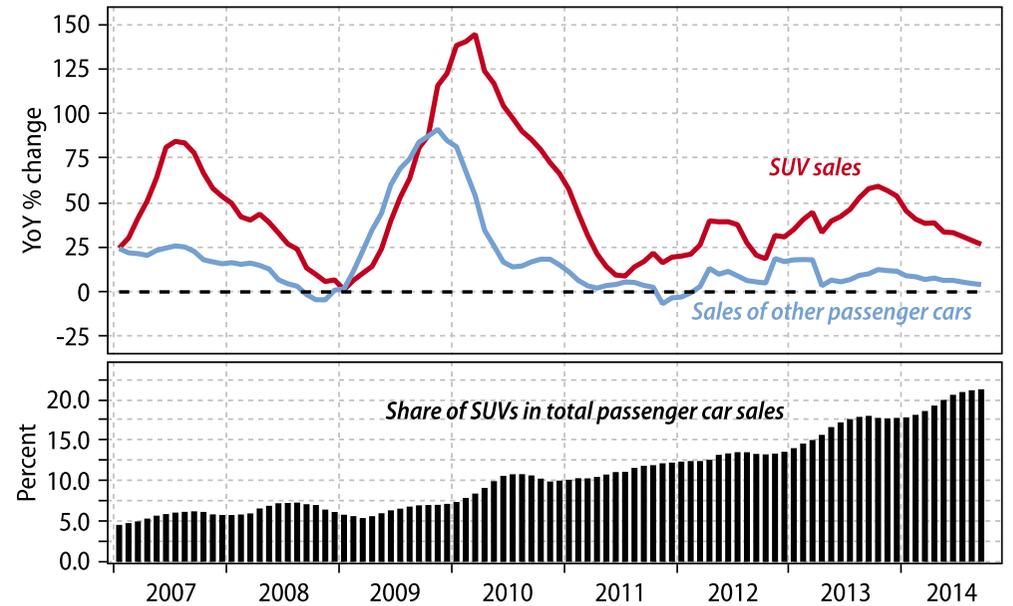


Gavekal Data/Macrobond

As household income rises, the propensity to spend on certain goods does not rise smoothly with income, but moves in steps. Potential markets for consumer goods can therefore grow many times faster than average income when many households are crossing certain income thresholds. We call this the “acceleration phenomenon”; it is now strongest for affluent consumers rather than middle-income ones.

## China's SUV sales are a bright spot in a slowing auto market

Unit sales of passenger vehicles, by type, 5mcm



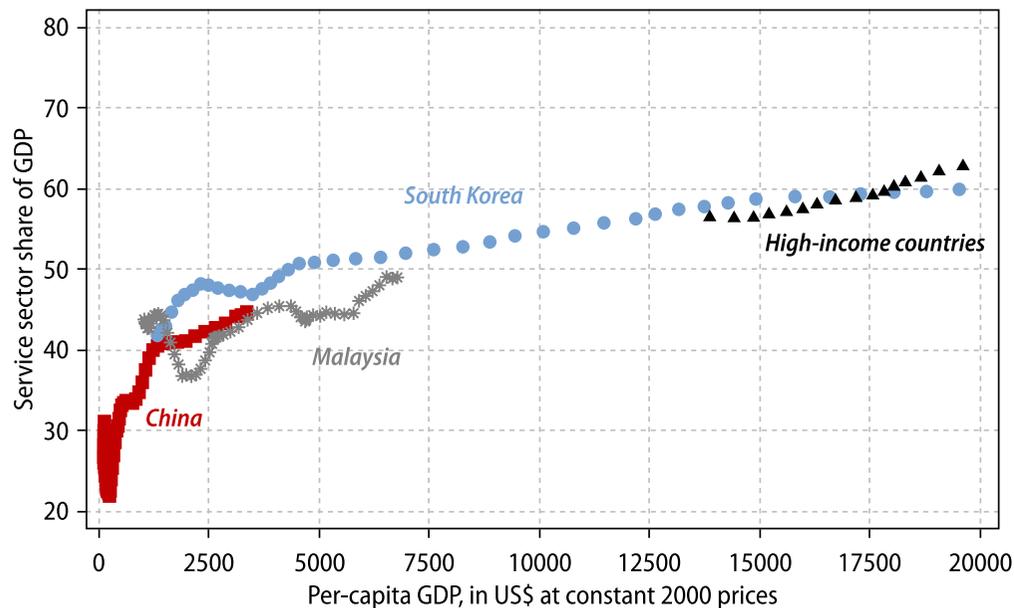
CEIC, Gavekal Data/Macrobond

The acceleration phenomenon in affluent consumers has led to a broad-based “upgrading” of consumption of many types of goods and services. Product varieties purchased by more affluent households are generally outperforming, and should continue to see strong gains for the rest of this decade given income dynamics. One example is in cars, where prestigious SUVs have been growing much faster than ordinary sedans.

# Services are the growth sectors of the future

## China's incomes are high enough for services to become more important

Service sector share and income level, 5ycma

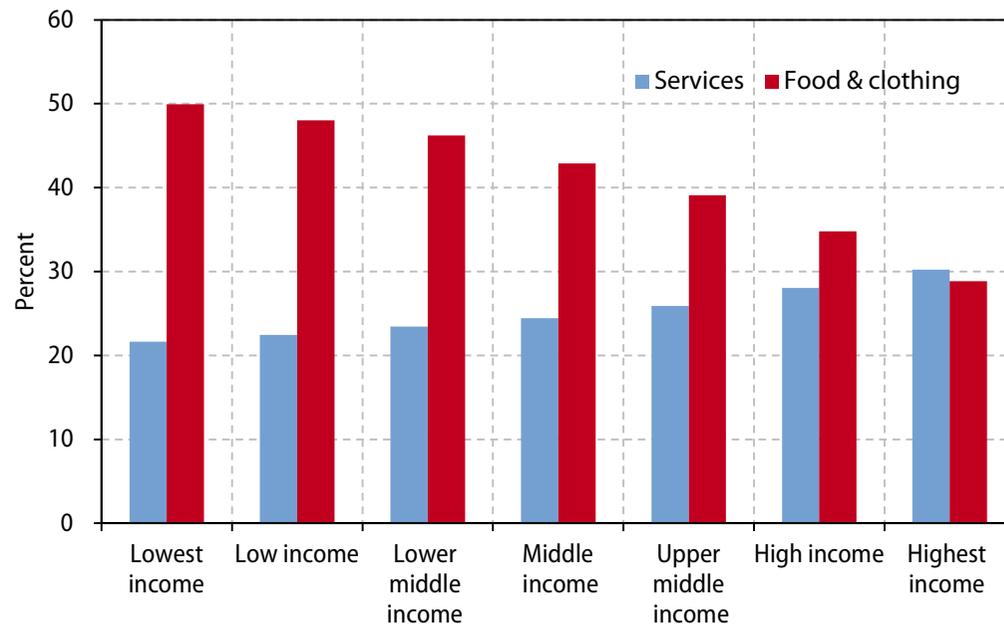


Gavekal Data/Macrobond

With China as a whole now firmly ensconced in middle-income status, incomes are high enough for the service sector of the economy to get more important. The service sector's share of GDP has increased by nearly 6 pp over the past decade, and recently overtook industry and construction to become the largest sector.

## Services become more important as income rises

Per capita urban household consumption, by type and income group, 2011



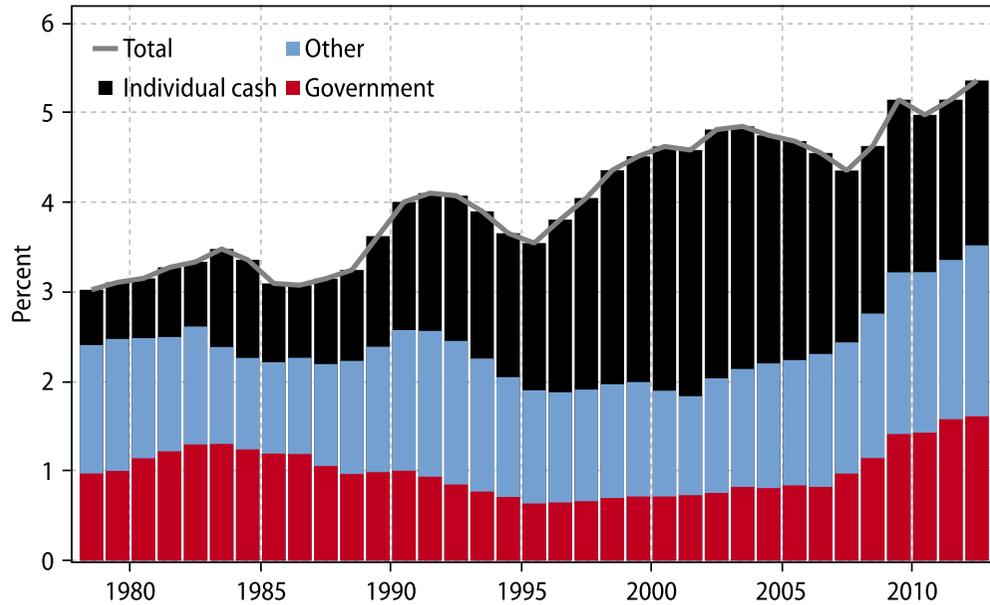
NBS, Gavekal Dragonomics research

The acceleration phenomenon will tend to drive service sectors generally, as higher-income households tend to devote a larger share of their spending to services. Sectors like healthcare, education and tourism should therefore have better future growth prospects, especially relative to traditional mass-market consumer goods.

# Healthcare supply is now rising to meet demand

## The share of healthcare in China's economy has steadily risen

Total expenditure on public health, ratio to annual GDP, by source

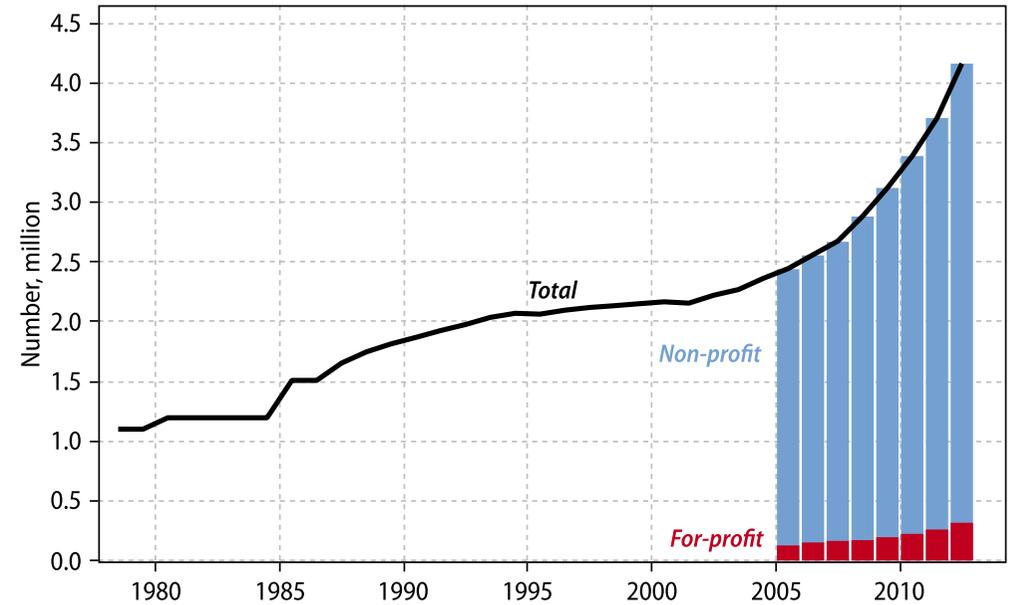


CEIC, Gavekal Data/Macrobond

Healthcare is one of the biggest and most important service sectors, and demand has been robust: its share of the economy has steadily risen over time. (Demand for healthcare usually grows faster than the rest of the economy, because of lower productivity growth in the labor-intensive sector.) With overall GDP growth slowing down, the steady gains in healthcare is making the sector increasingly interesting to many investors.

## After being stagnant for years, China's healthcare supply is surging

Number of beds in hospitals



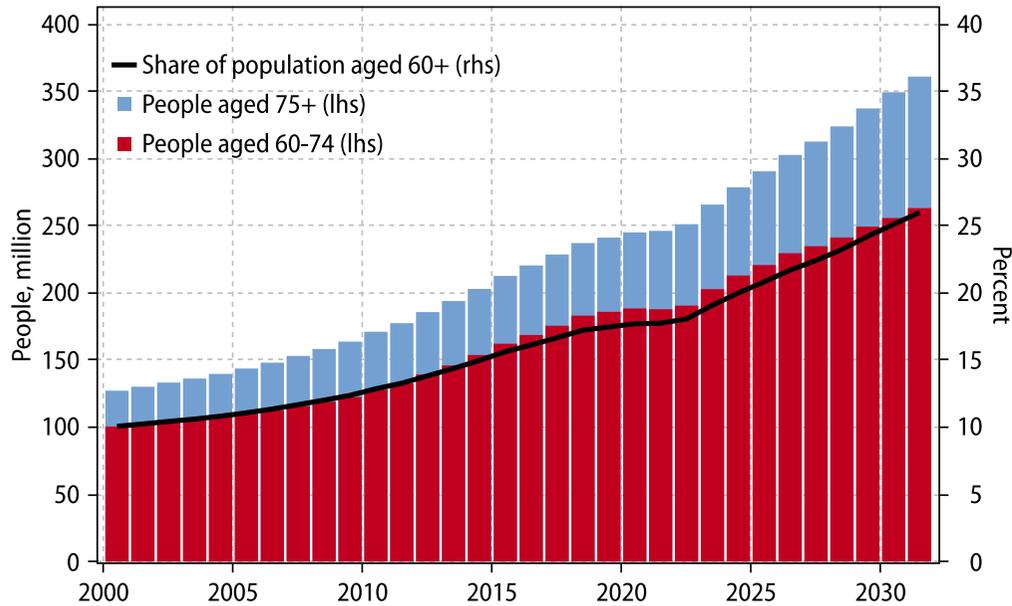
Ministry of Health, Gavekal Data/Macrobond

Healthcare supply has been dominated by the government, leading to bottlenecks because of under-investment. Deregulation especially since 2009 has started addressing this issue by opening more to private and foreign investment. The total capacity of the healthcare system, which we proxy by the number of beds in hospitals, has expanded dramatically under the reform. Thousands of new private hospitals have been founded in recent years.

# The aging population will drive demand for new services

## China's elderly population is growing fast

Elderly population by age brackets

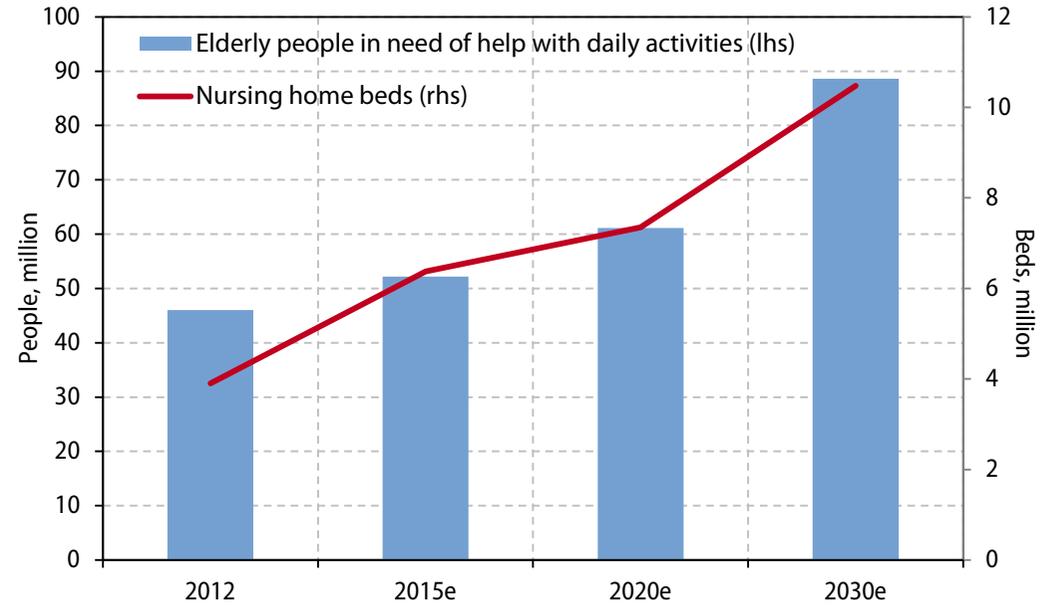


US Census Bureau, Gavekal Data/Macrobond

China already has 180m people aged over 60, and this population is forecast to grow to 245m by 2020 and 350m by 2030. According to some estimates, China will have a quarter of the world's entire elderly population by 2050. While this will impose some economic costs, it also means there is growing demand for goods and service targeted to the elderly.

## More people need nursing care and other assistance

Government targets for 2015 onward



US Census Bureau, CHARLS, Gavekal Dragonomics research

In China, most old people who need daily help receive assistance from their families. But the strain on busy family members is boosting demand for quality nursing homes. China had 3.9m beds in nursing homes in 2012, only enough to cover 2% of the population aged over 60. The government pledged in 2010 to raise this proportion to 3% by 2015, which means adding another 2.2m beds.

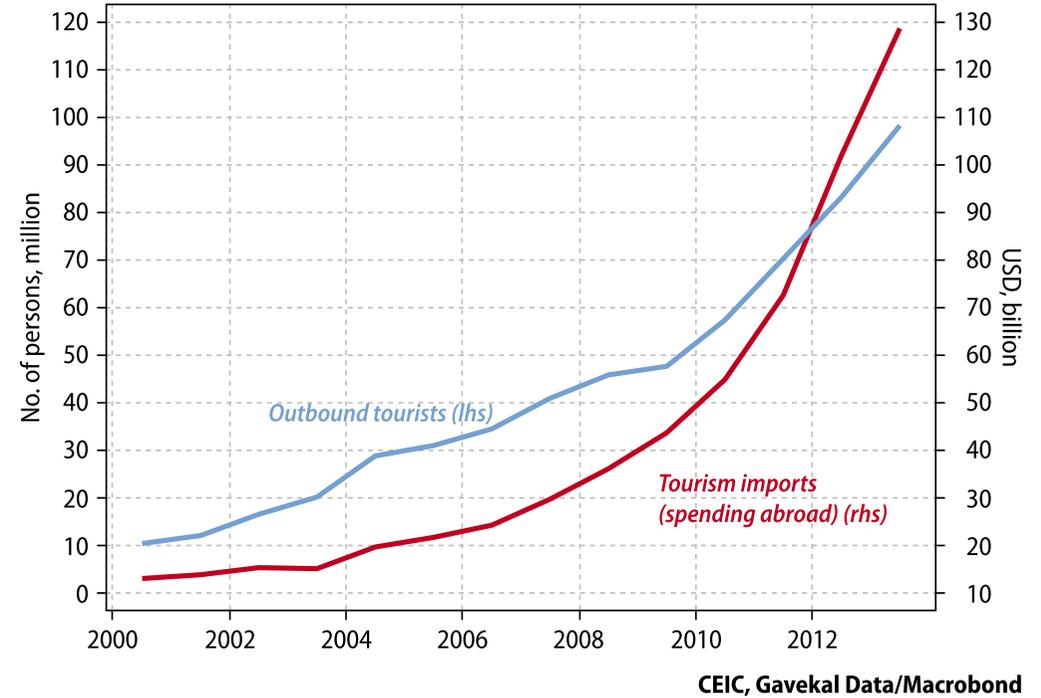
# Overseas tourism is booming

## International tourism continues to grow faster than domestic



Tourism is another high-growth service sector that has boomed over the past decade as household income rose. Fast growth in early years was mostly a function of a low base; today's high growth in international tourism is happening at very large volumes. Domestic tourism has however slowed, perhaps due to overcrowding on public holidays and better affordability for foreign trips.

## More Chinese tourists are going abroad and spending more



By 2012, China had overtaken Germany as the world's top tourism source market in both number of trips and spending. Average spending per trip has risen sharply. This is partly due to the acceleration phenomenon in high-income consumers. But it also reflects higher purchasing power from a stronger currency, and the fact that many consumer goods are cheaper abroad.

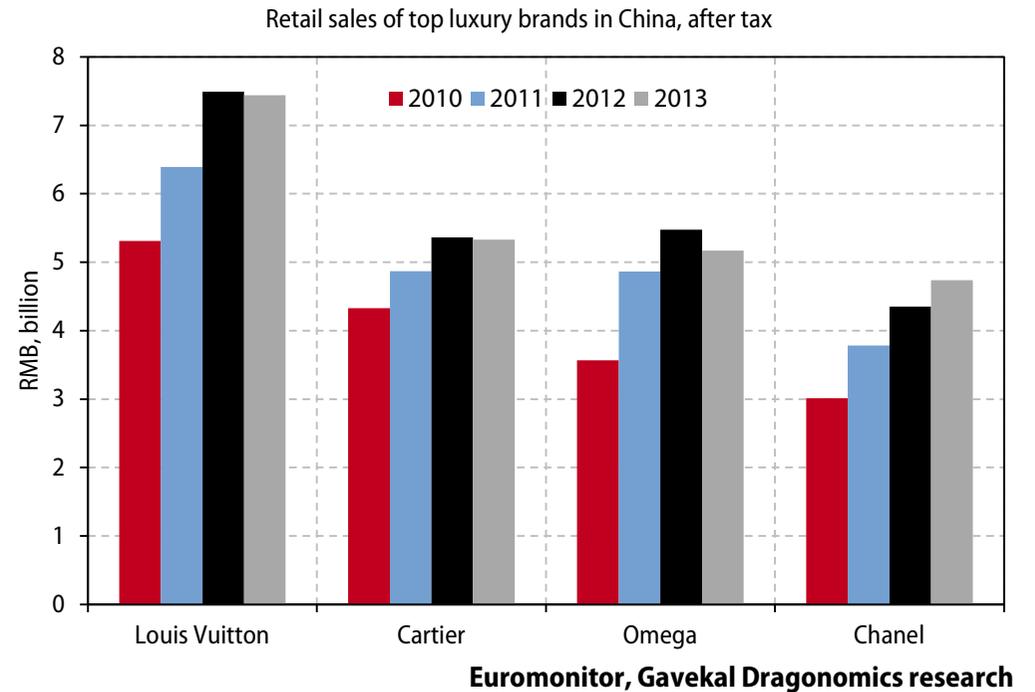
# The political winds are blowing against luxury goods

## Sales of luxury goods have slowed since the anti-corruption campaign



One side effect of all those Chinese tourists taking shopping expeditions to Hong Kong and Paris is a slowdown in domestic sales of luxury goods. According to Bain, over 60% of luxury consumption by Chinese consumers since 2012 has taken place overseas. But the launch of Xi Jinping's anti-corruption campaign made things worse, by cracking down on conspicuous consumption and official gift-giving.

## Most top luxury brands suffered negative growth in 2013

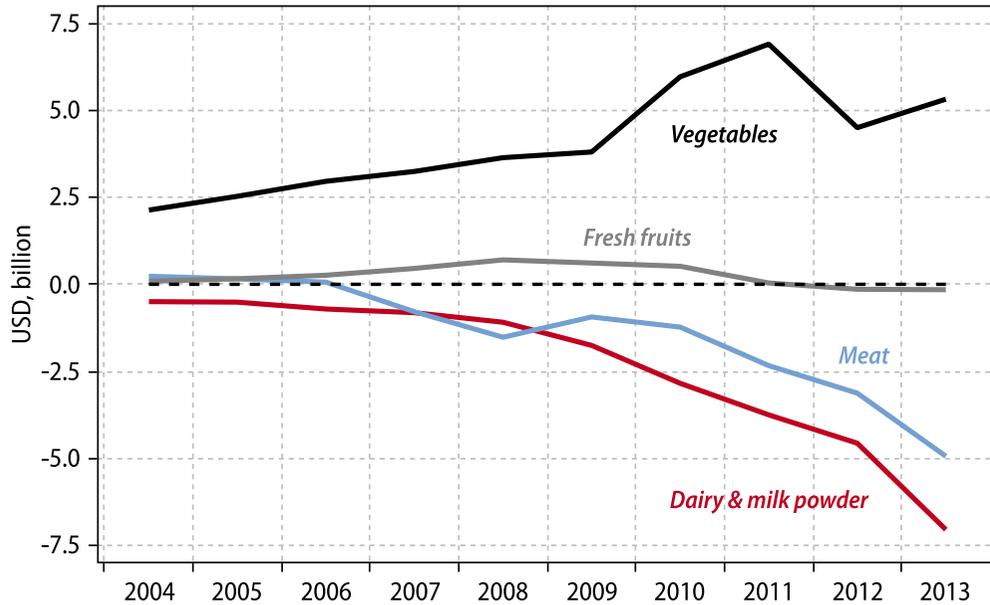


Expensive dinners with officials and SOE executives are now out of favor, and gifts frowned upon. Watches and wine are the two major luxury categories which suffered negative growth in 2013. And seven out of the top 10 luxury brands saw their China sales shrink in 2013. Top officials have declared that the tougher anti-corruption environment will be a permanent change rather than a one-off campaign.

# Food safety concerns have permanently shifted consumer habits

## Food safety concerns can both boost imports and depress exports

China's trade balance in selected food products

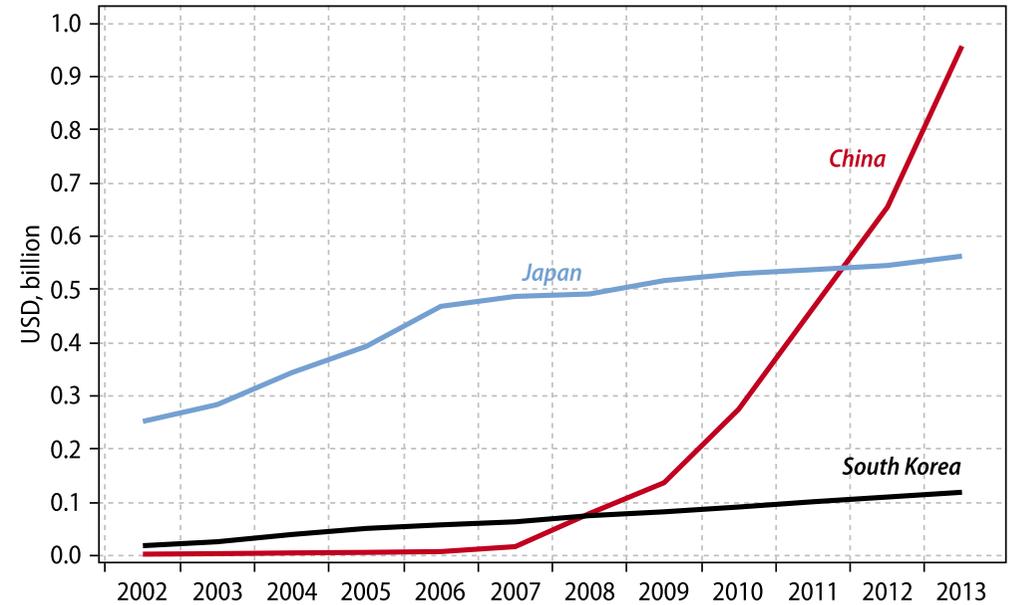


International Trade Center, Gavekal Data/Macrobond

A spate of serious scandals related to contaminated food and infant formula has made food safety a huge public issue since 2008. Trust in domestic brands has been hurt by the scandals, leading many consumers (especially affluent ones) to prefer imported goods. This is most obvious in dairy and to a lesser extent in meat products, where China now has widening trade deficits.

## China's organic food market has taken off amid food safety concerns

Sales of packaged organic foods (ie, excluding fresh produce)



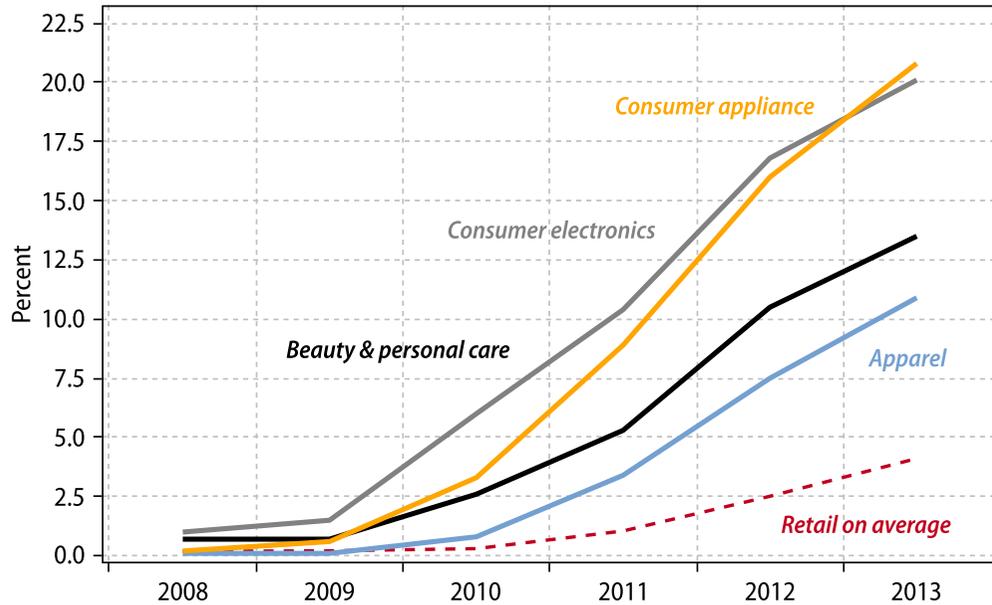
Euromonitor, Gavekal Data/Macrobond

Sales of organic products, especially milk, have also boomed since 2008, with consumers seeing the certification as a signal of higher quality. China had US\$957mn in organic product sales in 2013, more than 10 times the US\$79mn in 2008. But growth may be limited by toughening government regulation, which has made gaining certification quite difficult.

# E-commerce and online payments are surging

## Internet penetration in different retail sectors

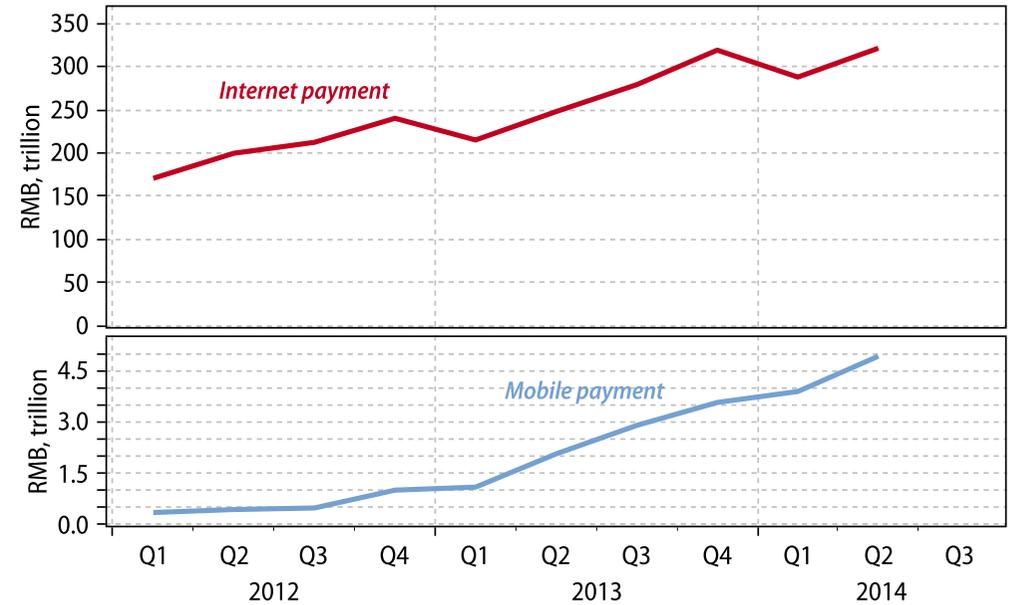
Share of internet retailing in total retailing



Euromonitor, Gavekal Data/Macrobond

## Online payments are growing rapidly, and mobile is starting to take off

Volume of transactions, by payment channel



PBOC, Gavekal Data/Macrobond

After Alibaba's blockbuster IPO in New York, few investors are unaware of the growth in Chinese e-commerce. This is a structural change in consumer behavior that is leading to rapid growth in internet retailing—a trend that is largely unrelated to cyclical changes in consumption growth. China's retail industry has been transformed over the past three years, but the share of internet retailing is still relatively low.

The corollary of more internet shopping is greater use of online payments. But now many people are starting to shop on their phones rather than on desktop PCs, and mobile payments began taking off in 2013—and jumped by 240% YoY in 2Q14. The pace of change is a challenge for traditional offline merchants, but it also offers them an opportunity to connect offline markets with online shoppers.

# Contact and disclaimer

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