From Mao to the mall

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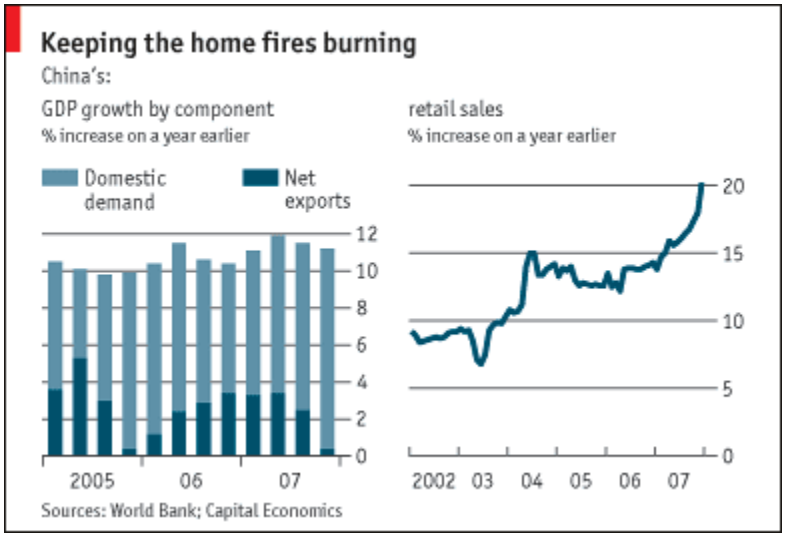
Amid all the global gloom, the good news is that China is turning into a nation of spenders, as well as sellers

THE past year has seen a lively debate among economists about China's rapid economic growth. Some, such as Brad Setser from the Council on Foreign Relations, believe that exports have been the main generator; others, like UBS's Jonathan Anderson and *The Economist*, think that domestic demand—spending on roads and railways, cars and clothes, and the like—has been the driving force. Just now, a lot turns on this argument: both how badly China's economy could be hurt by an American recession and also the extent to which Chinese spending could help to prop up the rest of the world economy. Some new figures suggest Chinese demand is rising strongly enough to help offset the increasing weakness in China's export markets. That could be good news for the world at large.

It is certainly true that China's current-account surplus rose to a record 10% of its GDP last year, which means that it produced a lot more than it consumed and so relied on foreigners to buy the excess. But it is the change in a country's trade surplus, not its absolute size, which matters for GDP growth. The increase in net exports (exports minus imports) has never been the main source of China's growth. It contributed two to three percentage points to annual GDP growth between 2005 and 2007, whereas domestic demand (consumption and investment) added eight to nine percentage points. But the latest figures show that exports have become even less important as a driver of growth. The World Bank's latest *China Quarterly Update* suggests that net exports contributed only 0.4 percentage points to GDP growth in the year to the fourth quarter of 2007 (see left-hand chart). Overall GDP growth slowed only modestly (to 11.2%) because of faster growth in domestic demand, which contributed an impressive 10.8 percentage points.



The significance of all this is that although China's headline GDP growth is widely tipped to slow to 9-10% in 2008, if a bigger chunk of this growth comes from domestic consumption and investment, then in absolute dollar terms China could well contribute more to global demand this year than in 2007.

Dragonomics, a Beijing-based economics-research firm, forecasts that the contribution of net exports to GDP growth will actually fall to zero during 2008, but this will be partly offset by strong growth in investment and consumption. After growing by an average of $80 billion during each of the past three years, China's trade surplus is likely to remain more or less flat this year. Export growth fell from 28% in the year to the first quarter of 2007 to 22% by the fourth quarter because of weaker American demand and the impact of a stronger yuan.

Meanwhile import growth surged from 18% to 26% on the back of strong industrial and consumer demand. In other words, Chinese imports are now growing faster than exports. China's trade surplus widened by only 12% (in dollar terms) over the year to the fourth quarter, compared with an increase of almost 90% in the first half of last year. This was partly due to higher oil prices that increased the value of imports, but even in inflation-adjusted volume terms the surplus stopped growing in the latter part of last year.

Time to open their wallets

Not only did more of China's growth come from domestic demand late last year, but there were also signs of a "rebalancing" of the economy from investment towards consumption. Using figures from China's National Bureau of Statistics, Mark Williams, an economist at Capital Economics, a London-based research firm, calculates that in 2007 consumption accounted for a bigger slice of GDP growth than investment for the first time in seven years. Government restraints on bank lending caused investment growth to slow slightly, whereas consumer spending picked up. The often-quoted monthly figures on fixed-asset investment still show annual growth of over 20%, but these figures are misleading. Measured on the same national-accounts basis as GDP, to exclude property and land sales, real investment rose by a more modest 11% in the year to the fourth quarter, less than the growth in real consumption.

China's consumer-spending data are notoriously murky. The annual rate of growth in retail sales has surged from 13% in early 2006 to 20% in December of last year (see right-hand chart). Some sceptics argue that this increase is mainly due to a rise in inflation. However, the consumer-price index is not the appropriate deflator because it gives a much higher weight to food (the main source of the recent surge in inflation) than the share of food in total retail sales. Frank Gong, an economist at JPMorgan, argues that using a more appropriate deflator, real spending has clearly accelerated, especially on household goods. One important stimulus is that last year real urban disposable income per head rose faster than GDP for the first time in five years. This should help to keep consumption growing rapidly in 2008.

A growth rate in China driven more by consumption than by exports and investment is exactly what the American government has been demanding for several years. Indeed, it might be hoped that if China's trade surplus stops expanding and consumer demand plays a bigger role in growth, international trade tensions should subside. The snag is that even if net exports were no longer contributing to China's growth, its trade surpluses with America and Europe would continue to loom embarrassingly large. And, says Mr Williams, as Chinese exporters move into higher-value products, they will become more of a threat to Western producers.

In 2008 China will probably suffer its first slowdown in growth for seven years. But strong domestic demand should mean that an American recession would not bring the Chinese economy to a screeching halt. Indeed, to the extent that the economy was starting to

overheat, a slowdown will be welcomed by Chinese policymakers. And if almost all of the slowdown comes from net exports, while domestic spending remains robust, then the whole world can cheer, too.