

## Hu is Saving in China?

A penny saved may be a penny earned, but in China a penny saved is usually invested in an infrastructure project or an increase in manufacturing capacity. China's gross domestic savings rate, after averaging 40% or so of GDP for most of the 1990's, has grown over the past couple of years to close to 50% of GDP. This is an unprecedented number, and while a portion of this saving has been invested abroad in US Treasury bonds — thus funding the US current account deficit and keeping US interest rates low — the vast majority has been invested in the domestic Chinese economy. Gross capital formation was around 45% of GDP last year, and it powered an economic expansion that saw GDP rise by 9.5%.

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So where exactly is all this Chinese saving coming from and where is it going? Household savings rates in China, while high, do not explain the nation's high savings rate as a whole. As the following chart from the IMF's World Economic Outlook shows, high savings rates among enterprises, in the form of retained earnings, and a high public savings rate have been driving Chinese savings and investment.

Here's how Louis Kuijs of the World Bank explains the role of the Chinese government:

### Government

saving is remarkably high compared to other countries, and is much higher than suggested by the headline fiscal data. It reached 7.5 percent of GDP in 2001 (it is assumed to have remained roughly at that level in 2002-03). As a result, the government runs a significant saving-investment surplus, which forms an additional financing source. Indeed, in addition to its own investment, the government finances investment via capital transfers to state-owned enterprises in the power, electricity, water, transport, and other infrastructure sectors. The transfers were 6.2 percent of GDP in 2001 and are assumed to have remained at roughly that level in 2002-03. Investment by enterprises established by the government financed by capital transfers could be seen as adding to overall public investment.

Interestingly, China has been running budget deficits even as public sector savings have been increasing. How can a fiscal deficit, which by definition is government dis-saving, magically turn into excess savings? Chinese financial and economic statistics are often more akin to a riddle wrapped in an enigma than they are to the gospel truth. That said, it appears as if public investment in physical infrastructure projects are being counted as savings. If anyone has a good explanation as to these accounting discrepancies, we would like to hear it. The following chart tracks the increase in China's public deficit.

In any event, Chinese investments have thus far been successful in providing high growth rates. But China may have a hard time making the adjustment from an investment and export led growth strategy towards a more balanced, consumption-oriented economy. For one, much Chinese investment has been funded through either capital transfers from the state or through the retained earnings of enterprises. As these investments have not undergone any financial intermediation through the banks or capital markets, it means that no one has been doing their due diligence. Normal accounting standards and profit motives are not necessarily driving investment decisions. These investments may prove successful in the long term — or they may not, nobody really knows. It is likely, however, that a large proportion of these investments will result in over capacity.

Chinese investment flows have been especially heavy to the following sectors: infrastructure, aluminum, steel, autos, cement and real estate. If, say, the real estate sector finds itself substantially overbuilt, that could lead to job losses in the construction industry. But since its legitimacy is largely based on providing continued economic growth, China's government is very sensitive about unemployment, especially as it is engaged in an ongoing restructuring of the SOE sector.

So if China becomes plagued by over-capacity in non-import competing sectors, it will lean all the more heavily on exports as an engine of job creation. If it faces over capacity in the export sector, it will likely dump the excess capacity onto the global markets rather than allow substantial job losses that could threaten social stability. Moreover, while China is making efforts to modernize its financial system and increase the role of the capital markets, these efforts will take some years to bear fruit. Eventually, efficient bond markets could both allow corporations to fund expansions through borrowing and provide the discipline necessary to avoid uneconomic investments. Increasing consumer access to credit could reduce the current reliance on savings to finance big household

purchases.

But until then, it will be hard for China to take part in any major restructuring of the global savings imbalance. China will need to consume more and save less - just as the US must get its fiscal house in order - in order to redress the imbalance. In the meantime, lets hope that the mandarins directing investment in China, and not least Chinese President Hu Jintao, know what they're doing.