

SPECIAL REPORT ON CHINA CONSUMPTION

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TAPPING THE IMPENDING CONSUMPTION BOOM IN CHINA

SUMMARY

- China's private consumption was around USD3.3trn in 2013, almost as large as Germany's GDP. However, there is still huge room for Chinese consumption to grow at a fast pace. China's private consumption represents only 36% of its GDP, compared to the world's average of 60%.
- China's consumption will be boosted by a set of ongoing and expected structural reforms. The establishment of a universal medical insurance scheme and a minimum pension in the rural sector will substantially reduce precautionary savings and promote consumption. The rural land reforms will also transfer wealth from the state to village residents, creating an enormous wealth effect. Household earnings will be lifted by rising wages and labour productivity.
- A rebalancing China means consumption growth will soon outstrip GDP growth. By 2020, China's private consumption will represent 44% of its GDP and will be around 70% of the size of the US consumer market, compared with just 40% today. China's consumer sentiment will exert a larger impact on economic growth, the inflation outlook, and monetary policy.
- China's rising middle class will help drive the consumption growth. Over the next few years, 100m more middle-income households will enter the market and their spending will make up two-thirds of the total urban consumption, compared with just one-third in 2012.
- To anticipate this trend, a tool is needed to better measure the pulse of Chinese consumers. While existing consumer confidence surveys are available, consistent and objective private-sector sponsored surveys are few. To fill the void, ANZ teamed up with Roy Morgan Research to develop a new index that gauges China's consumer confidence and inflation expectations. We are delighted to announce the results for the period of January-May 2014 separately.¹

¹ This report has been prepared as part of the launch of the ANZ-Roy Morgan China Consumer Confidence Index. A press release and report on the Index will be available on ANZ.com from 09:30 CST.

TAPPING THE IMPENDING CONSUMPTION BOOM IN CHINA

STYLISTED FACTS OF CHINA'S CONSUMPTION

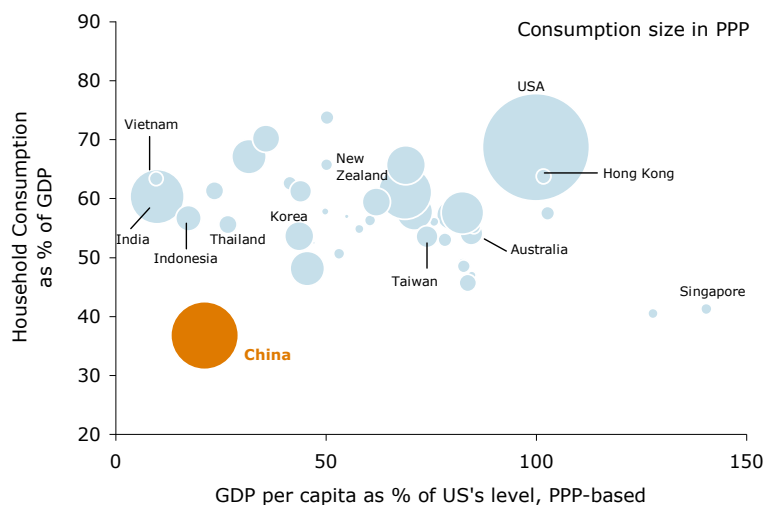
China declared to deepen reforms comprehensively after the 3rd Plenum in November 2013. The nation strives to double its per-capita income by 2020 from 2010 levels by shifting from an investment-led growth to a consumption-driven growth.

Meanwhile, concrete structural reforms are under way or expected to take place in order to achieve this grand strategic shift.

- A nationwide health insurance system has been set up, covering more than 96% of the 1.35bn population.
- A minimum pension has been established for rural retirees, who previously relied on family-based solutions.
- The ongoing land lease title reform will transfer the de facto land ownership from the state to rural farmers, creating a sizeable wealth effect that will boost rural consumption.
- A unified pension system is due to be created in the following years, and it will not only enhance China's social security system but also have far-reaching implications for China's capital markets.
- Further reforms in China's education and health care sectors will help reduce the precautionary savings of Chinese consumers and unleash their consumption potential.
- The government is also addressing the issue of rising property prices facing low-income earners and young people by reintroducing a public housing program.
- The overarching theme of rebuilding China's social safety net, together with an accelerating urbanisation process focused on people's welfare, will become a centrepiece in the overall development strategy for the remainder of the decade.

Even by today's standard, China's consumption deserves serious attention. The size of China's private consumption is gigantic. In 2013, its nominal value was estimated to be USD3.3trn, representing only 36% of China's GDP but equivalent to the 2013 German GDP or the whole Japanese economy in Purchasing Power Parity (PPP) terms. Given its prominent size, China's consumption is not only locally but also globally relevant and significant.

FIGURE 1. CHINA'S PRIVATE CONSUMPTION IS GIGANTIC



Source: CEIC, ANZ Research

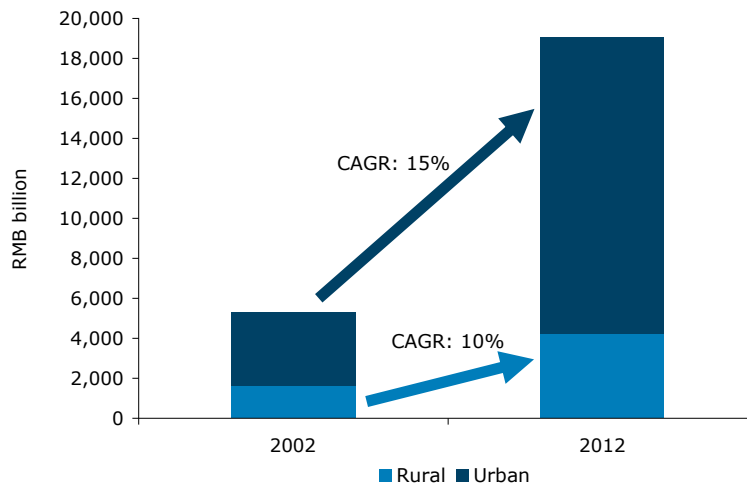
TAPPING THE IMPENDING CONSUMPTION BOOM IN CHINA

However, China’s private consumption to GDP ratio has been way below the international average. According to the World Bank, private consumption represented 60% of world GDP in 2012. For countries categorised as the middle-income group - to which China belonged in 2012 - the average consumption ratio was 55% of GDP or 19ppts higher than that of China. China’s consumption ratio has been falling over the past few decades.

URBAN HOUSEHOLDS TEND TO DRIVE CHINA’S CONSUMPTION

Urban households tend to drive China’s consumption as they represent 70% of total household consumption. As China’s urbanisation accelerates in the coming decade, these households will play an important role in boosting China’s consumption.

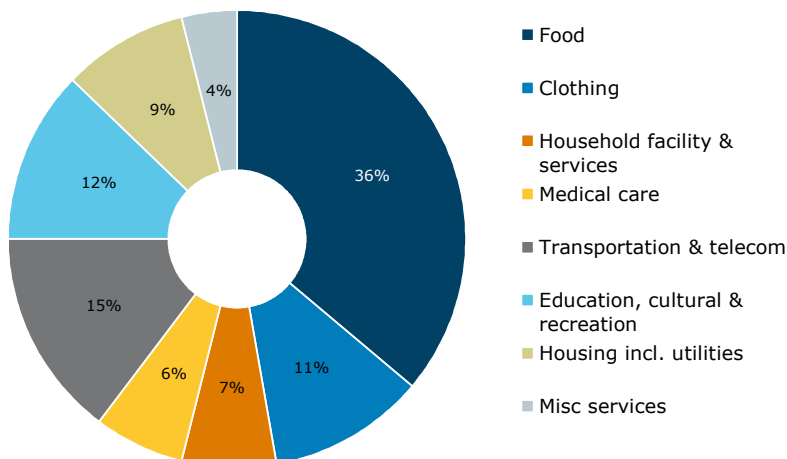
FIGURE 2. URBANISATION LEADS CONSUMPTION GROWTH



Source: CEIC, ANZ Research

China’s household consumption patterns have changed radically over the last decade. As income increases, the proportion spent on food has progressively declined, although it still represents more than one-third of the total. Accordingly, the composition of consumption goods has experienced a significant shift, with consumer durables or discretionary consumption now twice as important as non-discretionary goods, compared with 50-50 a decade ago.

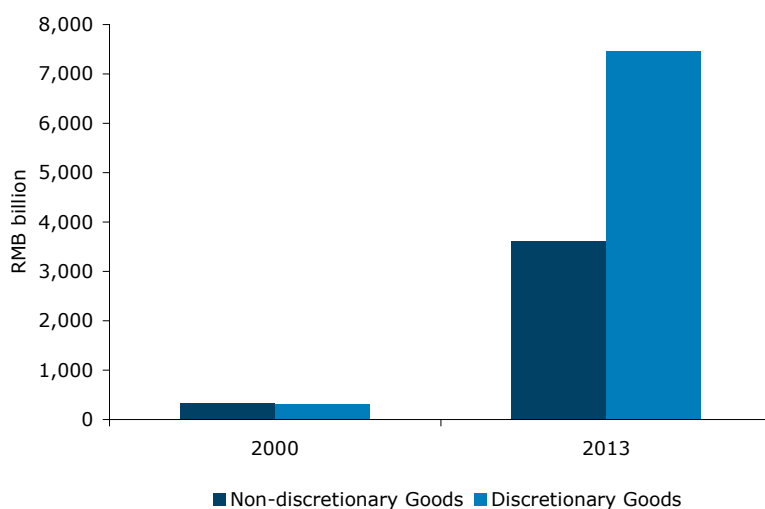
FIGURE 3. URBAN HOUSEHOLD EXPENDITURE BY COMPONENTS (2012)



Source: CEIC, ANZ Research

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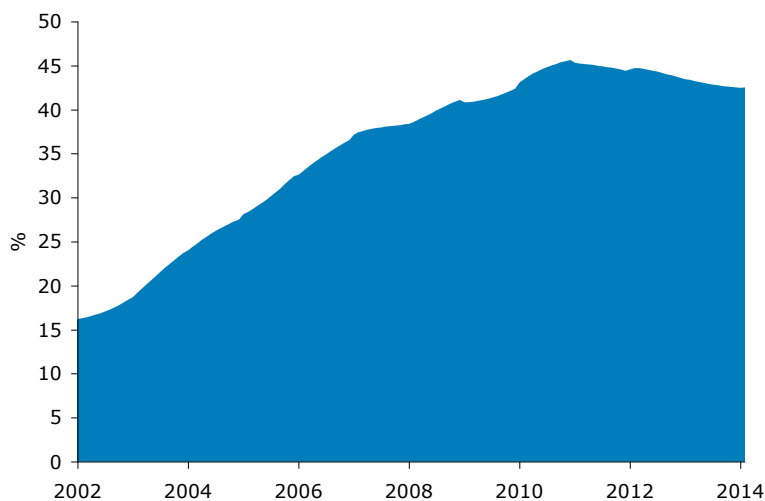
FIGURE 4. RETAIL SALES OF DISCRETIONARY GOODS



Source: CEIC, ANZ Research

Besides electrical appliances and electronic products, car ownership per household has jumped by 36-fold from 2001 to 2012. Automobiles, petroleum and other related products represent more than 40% of total retail sales. This growing trend will continue with rising car ownership as there were only 22 cars per 100 households in 2012.

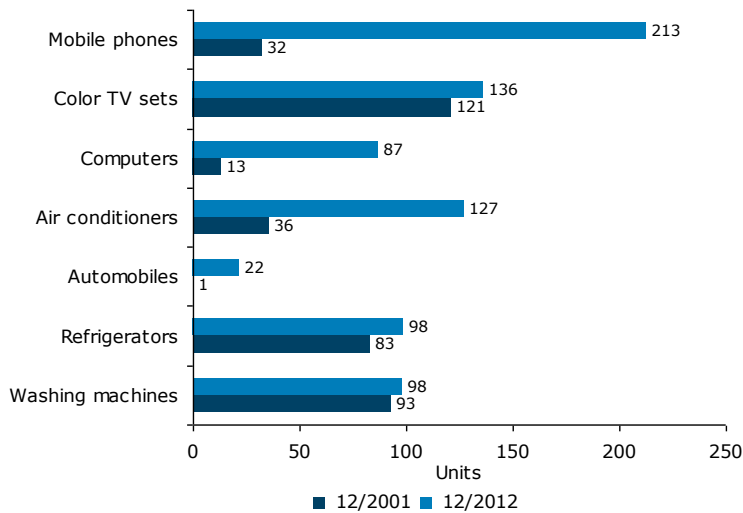
FIGURE 5. PROPORTION OF AUTO, PETROLEUM & RELATED PRODUCTS IN TOTAL RETAIL SALES



Source: CEIC, ANZ Research

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FIGURE 6. CHINA'S OWNERSHIP OF DURABLE GOODS PER 100 HOUSEHOLDS

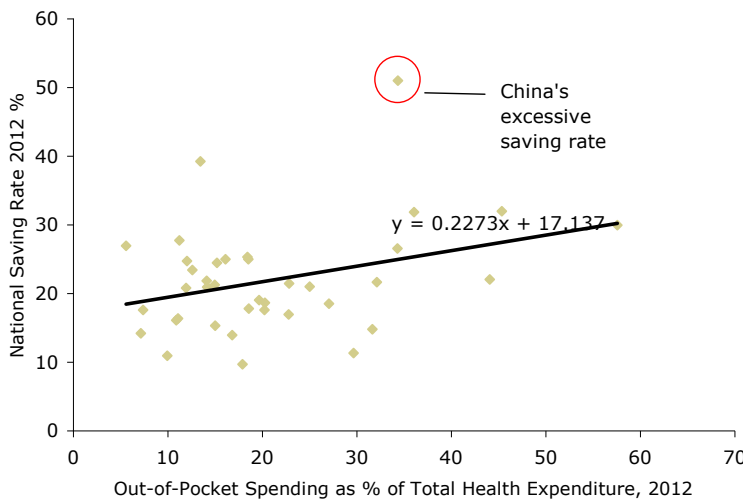


Source: CEIC, ANZ Research

STRUCTURAL REFORMS AND TECHNOLOGY CHANGE WILL SUPPORT CONSUMPTION

Improving social protection will lift China's consumption by reducing precautionary savings. China has set up universal medical insurance schemes covering urban and rural residents. The coverage will continue to expand going forward. In addition, China has announced it will unify the urban and rural social pension schemes by 2020. The increase in social protection will encourage people to save less and spend more.

FIGURE 7. CHINA'S HIGH SAVING RATE DUE TO LIMITED MEDICAL COVER



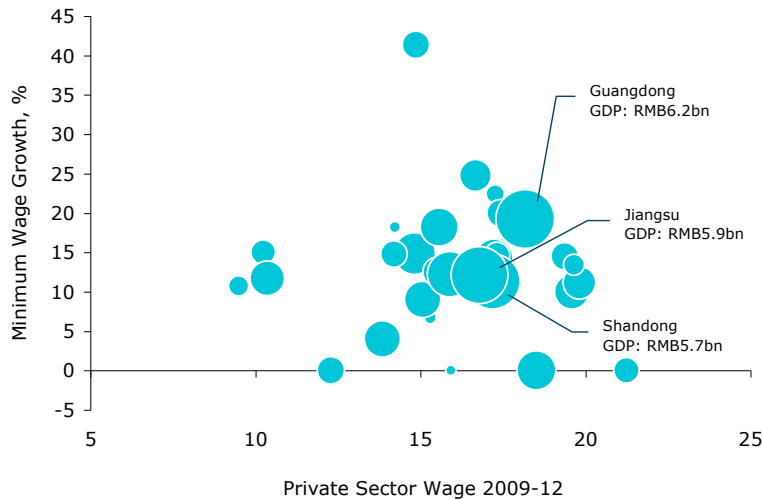
Source: WHO, World Bank, ANZ Research

Mobile and Internet technology will make China's consumption effortless. It is estimated that Chinese Internet users hit 600m in 2013 and e-commerce revenue has grown at a CAGR of 70% from 2009 to 2012. China is on its way to surpass the US and become the largest e-commerce market in the world. E-commerce transactions in China are projected to hit USD540bn by 2015, contributing to 10% of total global retail transactions. By 2020,

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China's e-commerce market is forecast to be larger than those of the US, UK, Japan, Germany, and France combined.²

FIGURE 8. WAGE GROWTH IN CHINA BY PROVINCE



Source: CEIC, ANZ Research

Ultimately, rising earnings will fundamentally boost consumption. China has strategically decided to increase household earnings. As both the manufacturing and service industries move up the value chain, labour productivity and hence earnings will be lifted. Tactically, the government tightened the labour contract law to encourage an increase in the minimum wage for urban workers. As a result, wage incomes have climbed quickly since 2010. Through various subsidy schemes and agricultural reforms, rural incomes have also increased rapidly. We believe that the ongoing land lease title reform will create a significant wealth effect for rural households and will also boost rural consumption in the coming years.

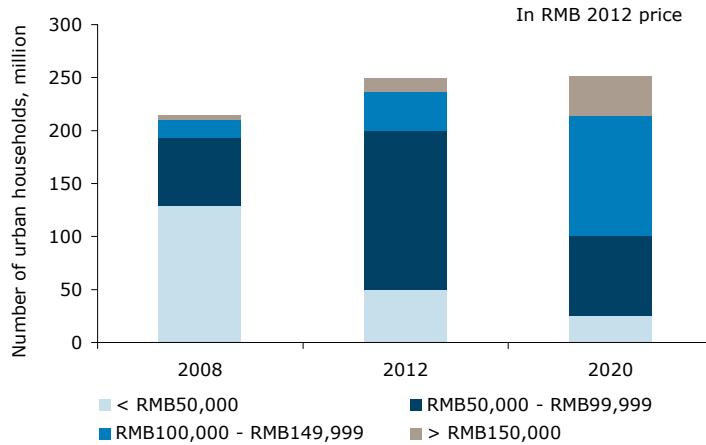
THE EMERGENCE OF A LARGE MIDDLE CLASS WILL CREATE A CONSUMPTION BOOM

The growing middle class will boost China's consumption. Based on a set of conservative assumptions, we have projected the consumption ratio of urban households of different income groups as well as their distribution within the Chinese population by 2020. In 2012, 15% of urban households earned between RMB100,000 and RMB150,000 (USD16,000-24,000) a year, representing 25% of total urban spending. By 2020, 45% of urban households will earn in that range and contribute to almost 40% of total household spending. The number of affluent households that make up China's top 5% of income earners today will expand threefold by 2020, creating additional consumption demand of RMB6.5trn or about USD1trn in today's value. The consumption by affluent households will constitute 26% of total purchase by urban households. **China's consumption boom will be empowered by the emergence of the middle class, turning the consumption-to-disposable income ratio from 76% in 2012 to around 82% by 2020.**

² <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Documents/China-360-Issue15-201401-E-commerce-in-China.pdf>

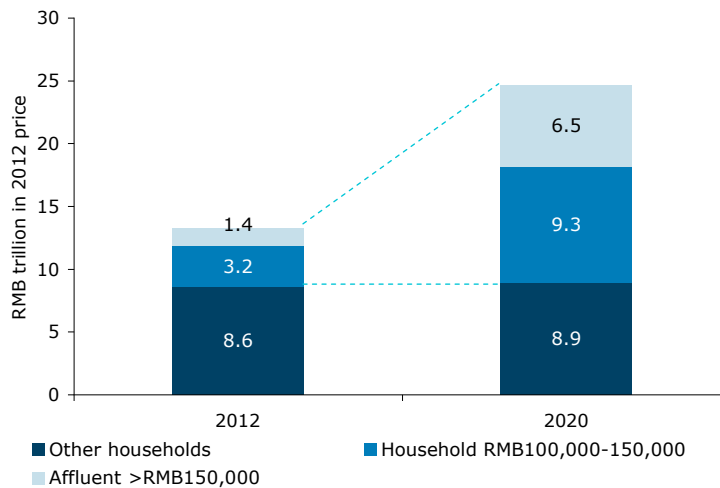
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FIGURE 9. THE MIDDLE CLASS WILL DOMINATE CHINA'S URBAN HOUSEHOLDS BY 2020



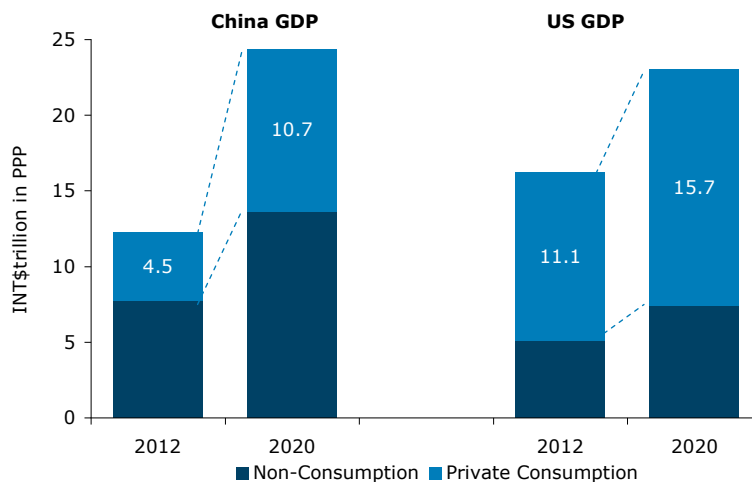
Source: National Bureau of Statistics, ANZ Research

FIGURE 10. HOUSEHOLD SPENDING BY INCOME GROUP



Source: National Bureau of Statistics, IMF, World Bank, ANZ Research

FIGURE 11. CHINA'S CONSUMPTION TO COME CLOSE TO US LEVELS

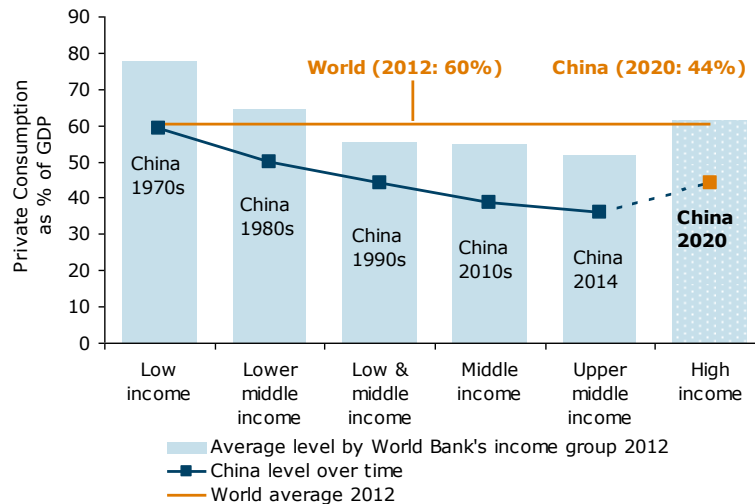


Source: World Bank, IMF, CEIC, ANZ Research

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As the economy continues to grow at an average real rate of 6-7% through to 2020, China will join the High Income group and the size of its economy will beat the US. The increase in consumption will outperform GDP growth by 1.2% a year. **By 2020, private consumption will represent 44% of China GDP and in PPP terms, it will be equivalent to almost 70% of the US level in 2020, compared with just 40% in 2012.**³

FIGURE 12. CHINA'S CONSUMPTION TO REBOUND AS GDP GROWS



Source: World Bank, OECD, ANZ Research

TRACKING THE CONFIDENCE OF CHINA'S CONSUMERS

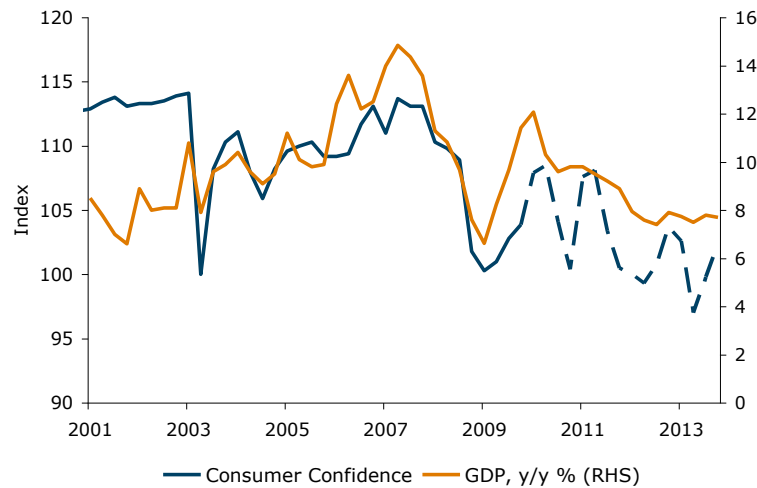
The growing 'consumer class' will become a more significant and stable driver of overall economic growth. For business, the changing landscape of China's consumption means abundant business opportunities. Taking financial services for example, the increasing consumption in China is bound to spur the growth of the under-developed consumer credit businesses. China will surely follow the experience of the emerging economies and the developed economies, but its size will be several times bigger. As e-commerce continues to prosper and the middle class is technologically savvy, the demand for electronic payment services will explode. With rising income, Chinese households will be able to use financial leverage in their purchases.

³ Nominally, China's consumption market is projected to reach USD8.1trn by 2020, compared with USD3.3trn in 2013.

TAPPING THE IMPENDING CONSUMPTION BOOM IN CHINA

Consumer confidence is an important tool to track China's growth momentum. We compared the movement of a consumer confidence index released by the National Bureau of Statistics (NBS) with China's GDP growth and other economic indicators (Figures 13-16). The level of consumer confidence was broadly in line with the economic momentum over a longer horizon, suggesting that consumer confidence will be a useful tool to track China's economic climate.

FIGURE 13. CHINA'S CONSUMER CONFIDENCE GAUGES GDP GROWTH



Note: The NBS expanded the sample size and scope of the Consumer Confidence Survey in 2009

Source: CEIC, ANZ Research

We also noticed that China's consumer confidence has become more volatile since 2008. Although it may be due partly to some methodology changes by the NBS after 2009, the fluctuation is not surprising as China's economy has opened up further in recent years, the global economy has become more volatile after the Global Financial Crisis, and China's growth has become more policy driven. However, with the quick reforms in China's social safety net, we expect China's consumer sentiments will become stabilised in the future. As China's consumers gain more global influence, a tool is needed to measure the pulse of Chinese consumers.

It is vital to have an accurate measure of consumer sentiment in China. While existing consumer confidence surveys are available, consistent and objective private-sector sponsored surveys are few. To fill the void, ANZ teamed up with Roy Morgan to develop a new market index that gauges China's consumer confidence, inflation and property price expectations starting from January 2014. Every month, we will survey 1,000 households across major cities in China based on a well-established methodology that has been used by Roy Morgan for many years across Asia Pacific. We believe that the ANZ-Roy Morgan Consumer Confidence Index and its sub-indices will provide policy makers, investors, corporates, academics and China's economy watchers with valuable insights into the Chinese consumer market and with the ability to identify inflection points in consumer spending behaviours, in addition to sectoral and market trends.

TAPPING THE IMPENDING CONSUMPTION BOOM IN CHINA

FIGURE 14. CHINA'S CONSUMER CONFIDENCE AND RETAIL SALES



FIGURE 15. CHINA'S CONSUMER CONFIDENCE AND PROPERTY PRICE

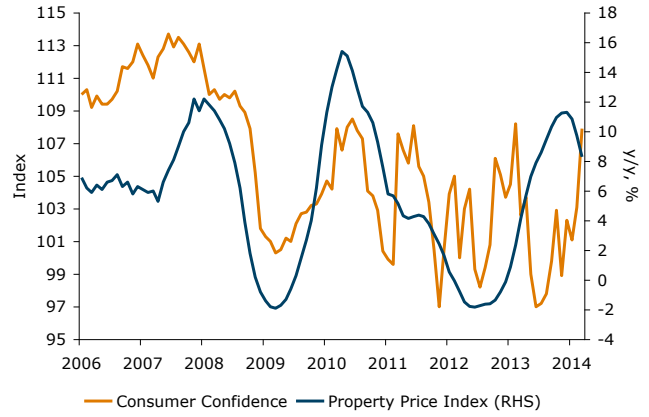


FIGURE 16. CHINA'S CONSUMER CONFIDENCE AND MACAU GAMING REVENUE

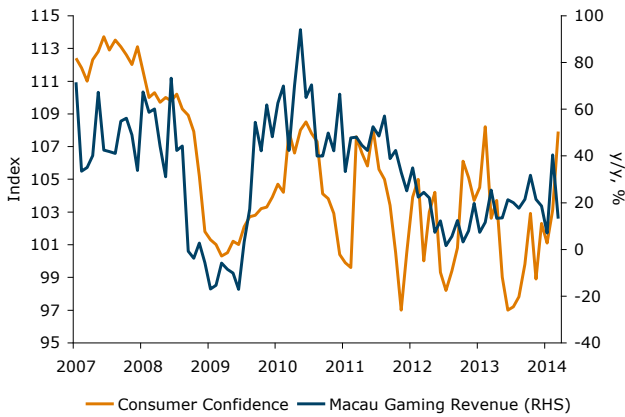


FIGURE 17. CHINA'S CONSUMER CONFIDENCE AND HONG KONG RETAIL SALES



Source: CEIC, ANZ Research

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