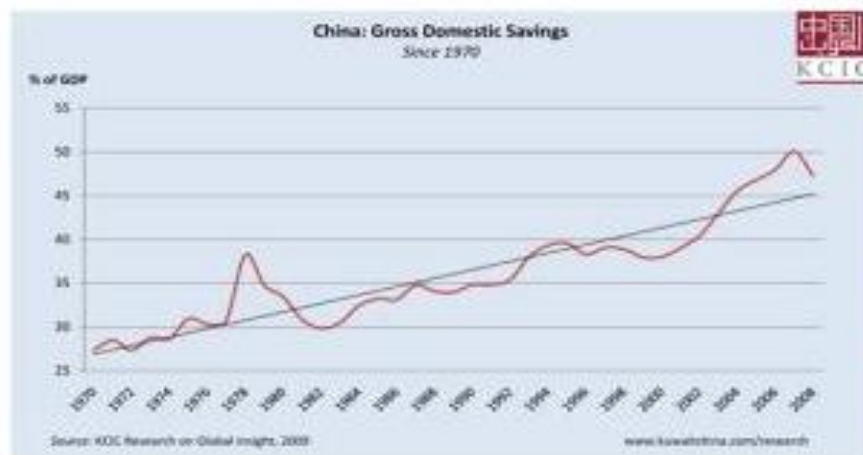


## KCIC WEEKLY ANALYSIS

### China needs to convert huge domestic savings into consumption, investment



Why is this graph important?

The graph shows the impressive rise of China's "gross domestic savings" over the last four decades. Between 1970 and 2008, Chinese savings - lifted by export receipts - rose from 27.4 to 47.3 percent of gross domestic product (GDP). In other words, the country is now sitting on a pile of cash. This is good, because savings can spur economic growth; according to economic theory, savings turn into investment, which creates employment and accelerates growth. Indeed, between 1978 and 2008, China's GDP grew at an average yearly rate of almost 10 percent. But it

is worth noting that over the same period of time, domestic savings grew faster than GDP. In other words, not all savings were spent at home; a good chunk left the country, to be invested by the Chinese government in U.S. Treasury bonds. No doubt, these savings still spurred China's growth, by funding U.S. demand for China's products. However, the ongoing global economic downturn is changing the rules of the game. Given the reduced international demand for Chinese exports, to sustain future growth China needs to be able to convert its huge domestic savings into domestic consumption and investment.

Why is this indicator important?

"Gross domestic savings" is the sum of: 1) household savings; 2) government surpluses; and 3) retained earnings of businesses. In China, all these three sectors save substantially. First, Chinese households save to protect themselves from risks associated with job insecurities, unforeseen medical expenses, and old age. Second, the government saves in order to fund its investment dependent development policies. And finally, corporate China saves to fund its expansion plans, which otherwise might not materialize, as a relatively underdeveloped financial market makes capital raising difficult. China's high savings represent a locked-up potential, as they can be translated into domestic consumption or investment, and these in turn contribute to sustained GDP growth.

What are the implications for the economy and the financial markets?

The Chinese government, fully aware of the need to invest at home its huge pool of domestic savings, is taking important measures to boost domestic spending on both consumption and investment. To make households feel more secure about their future, the government is planning to strengthen the social security net. In particular, in order to alter household spending and consumption habits, the Chinese fiscal authorities have initiated several programs in the area of public education, health care, social security, employment, and low-income housing. In 2009 alone, the central government has planned to allocate 728 billion Chinese yuan (106 billion U.S. dollars) - an increase of 29.4 percent compared to last year - for items directly related to people's well-being. The government is also working on a proposal to make Shanghai an important financial center by 2020, to grant businesses an easier access to capital markets.

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