



China retail

sales grow remarkably by 16% year-on-year

Why is this graph important?

The graph shows the recent performance of "retail sales" in China. In the first quarter of 2009, "retail sales" grew at about 16 percent year-on-year. This growth is remarkable because it is measured in real (inflation adjusted) terms: in other words, it is due to an increase in sale volumes rather than to rising prices. All this is impressive, but what does it mean? A sustained growth in "retail sales" suggests that private consumption - a key component of domestic demand - is healthy. As other components of domestic demand (for example, fixed asset investment and property sales) are also rising, this indicator confirms that the Chinese economy is recovering despite its very weak exports. In short, China is increasingly relying on its domestic - rather than on external - demand for its economic growth. Given the poor economic prospects in the U.S. and the EU and the important role of China in Asia, a recovery sustained by the Chinese domestic market could decrease Asia's dependence on "Western" consumers. Yes, "decoupling" is back in fashion.

What does this indicator tell us?

This indicator highlights the sale of goods and services at the retail (as opposed to wholesale) level. In other words, "retail sales" are all 'selling trades' carried out by a department store, a supermarket, a restaurant or a kiosk. Typically, "retail sales" include a broad range of items: food and clothing, cars and gasoline, building materials and furniture; and these are just a few examples. Because of the wide spectrum they cover, "retail sales" are widely used by investment professionals to assess the health of domestic consumption in a given economy.

China's "retail sales," if however, need to be interpreted with caution. The reporting units (for example, department stores) do not differentiate between their customers. Therefore, the data on sales cannot be disaggregated, and a clear breakdown between "household" and "non-household" consumption is not available. As a result, the data include expenses

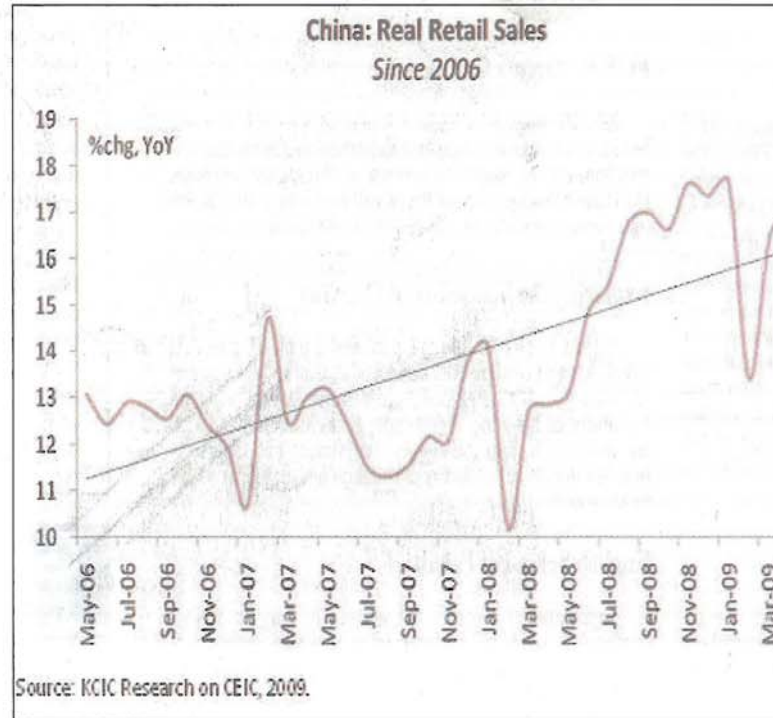
that should not be counted, and vice versa. For example, China's "retail sales" include government and corporate purchases at the retail level. This means that all government expenses in stores or shops - and even a government sponsored dinner in a restaurant - are inaccurately counted as "retail sales"; the same goes for a corporate meeting in a hotel. At the same time, the statistics do not include the sales of services, which are usually large (in other developing countries they can account for up to a third of consumption). Another important omission in coverage is the fact that the data do not include all purchases carried out using vouchers. In China, many companies use consumption vouchers as a form of compensation, and these expenses should be counted. Because of the recent crisis, in the first half of 2009 vouchers have been cut by many firms, but the "retail sales" numbers cannot capture the ensuing decline in final consumption. In sum, the growth in "retail sales" shown in the graph is possibly overstating what is really happening.

Despite all these caveats, the monthly "retail sales" data are a timely and reasonably reliable measure of China's domestic consumption. Over time, they have proven to be consistent with the trends of other more accurate - but less frequent - statistics, such as household expenditure data.

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

Over the last decade, strong international demand for Chinese products drove the country's economy to increasingly rely on exports for its growth. Between 1997 and 2007, the share of exports in China's GDP rose from about 20 to nearly 40 percent. Over the same period, the share of private consumption declined from 46 to 36 percent. This model - called "export-led growth" - worked very well for many years, but now is in trouble.

Over the next decade, as a result of the current economic and financial crisis, the U.S. and EU consumers will be unable to borrow and spend as heavily as they did in the recent



years. To achieve long-term economic prosperity China needs to change "growth model", and rely more on its own domestic consumption. Given the size of its population, it should be able to make it. However, the demographic leverage is a necessary, but not sufficient, condition. The government needs to step in and boost private consumption. The key issue is unlocking the potential of Chinese consumers - which has been constrained for decades - with policies able to address:

- 1) The current very uneven income distribution;
- 2) The structural reforms needed to provide a functioning social safety net;
- 3) The development of a consumer credit market.

Over the past 20 years, urban areas in the eastern coast (where the most developed cities, such as Beijing, Shanghai, and Shenzhen are located) grew richer, while the rural inner

regions - home to eight-million people, almost two-thirds of the total population - are lagging, poor and less-developed. Also, because of the absence of proper social safety net (i.e.: public delivery of education, healthcare and pensions), the Chinese are saving almost 30 percent of their income for possible future "rainy days" and - in doing so - are cutting today's consumption. Finally, the consumer credit market, still immature - in 2008, consumer credit accounted for 12 percent of GDP, compared with 40-60 percent in more developed countries - needs to be developed.

Well aware of all this, China's central and local governments have been pushing pro-consumption policies since the beginning of the current crisis. These policies target rural areas, with subsidies for the purchase of new cars or home appliances, but also urban areas, with car subsidies and consumption coupons. Moreover, a few long-term structural reforms

have been launched. First, in order to increase the purchasing power of the rural population, a (partial) land reform was implemented. Farmers have been allowed "to lease their contracted farmland or transfer their land-use rights." This way, they can earn extra income. Second, in February 2009, the government announced its long-awaited healthcare reform. Starting in 2010, each person covered by the system will receive an annual subsidy of 120 renminbi (approx. 5 KD), an amount set to rise over time. In 2011, 90 percent of the population is supposed to be covered by the state-sponsored medical insurance network, and both urban and rural residents should be able to have access to their universal healthcare account. Third, in June 2009, in order to boost consumer spending the Chinese government allowed domestic and foreign financial institutions to commercially launch consumer credit and credit cards.

China's private consumption potential, if fully realized, will not only enable its economy to sustain growth, but can also provide opportunities for partnering economies and for international investors.

The economies that export to China - for example by providing materials and finished goods - are bound to benefit from a rise in Chinese consumption. These economies include energy-rich countries (especially the oil-exporters in the GCC), and all neighboring Asian economies that are well integrated with the Chinese market, like Hong Kong and Taiwan.

If the policies mentioned above were to succeed in boosting income and consumer spending, the Chinese financial market is likely to convince a growing number of investors over the next few years. The rise of the Chinese middle class - more willing to spend rather than save - is just behind the corner. An increasing number of people are expected to start buying cars and cell phones, travel and go on holidays. As a result, all sectors related to domestic demand - and in particular consumer goods - are expected to grow, and are set to look increasingly attractive to foreign investors.