

How China plans to increase domestic consumption

By Torsten Weller, China Policy Analyst

- China wants to increase domestic consumption by at least 6% in 2021
- The wide-rural income gap, low education levels, and rising household debt pose significant challenges to higher consumer spending
- Hukou reform and better training of existing workforce will be key for China's development

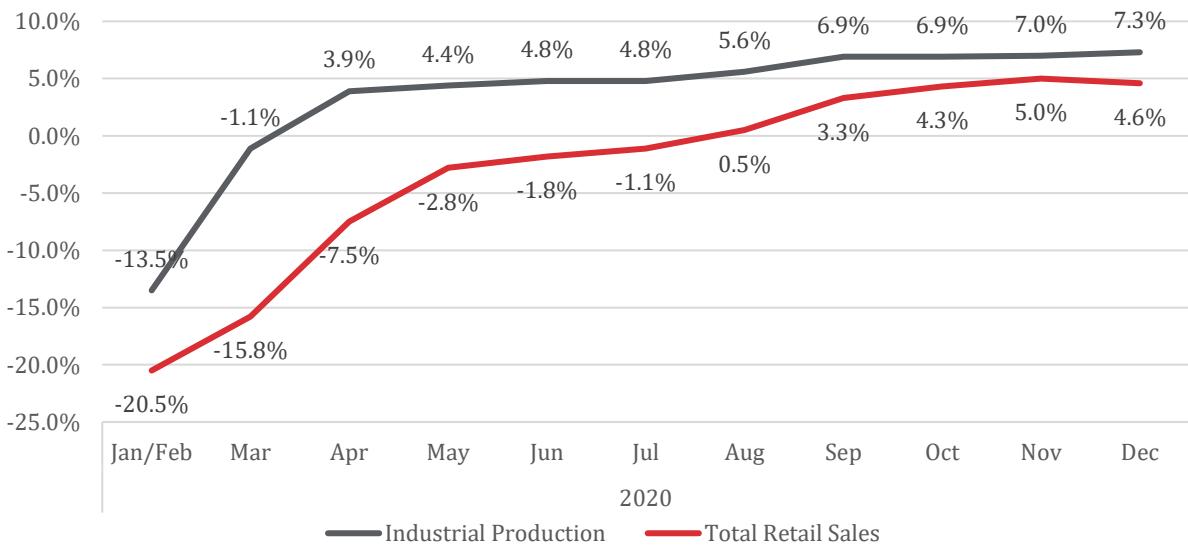
Summary

Increasing domestic consumption has become one of Beijing's major concerns. The 14th Five-Year-Plan, which was adopted in March, sets out an aim for Chinese disposable income to grow at least as fast as GDP¹. With this year's economic growth target set at 6%², this means that household spending should rise by at least the same amount.

Domestic consumption is also a key component of the government's new Dual Circulation Strategy, through which it plans to turn the country's vast consumer market into an irresistible magnet for foreign investment and businesses.

Yet achieving this goal will require significant reforms. Last year's pandemic has laid bare the weakness of China's domestic retail sector. Not only was it harder hit by the harsh lockdown measures, it also took much longer to recover. Whereas industrial production was back to normal in April, retail sales only reached pre-year levels in August 2020 – five months after the end of the national lockdown. In the end, retail sales in 2020 remained 4.8% lower than in 2019.

Graph - Monthly Chinese Year-on-Year Growth of Industrial Production and Total Retail Sales in 2020



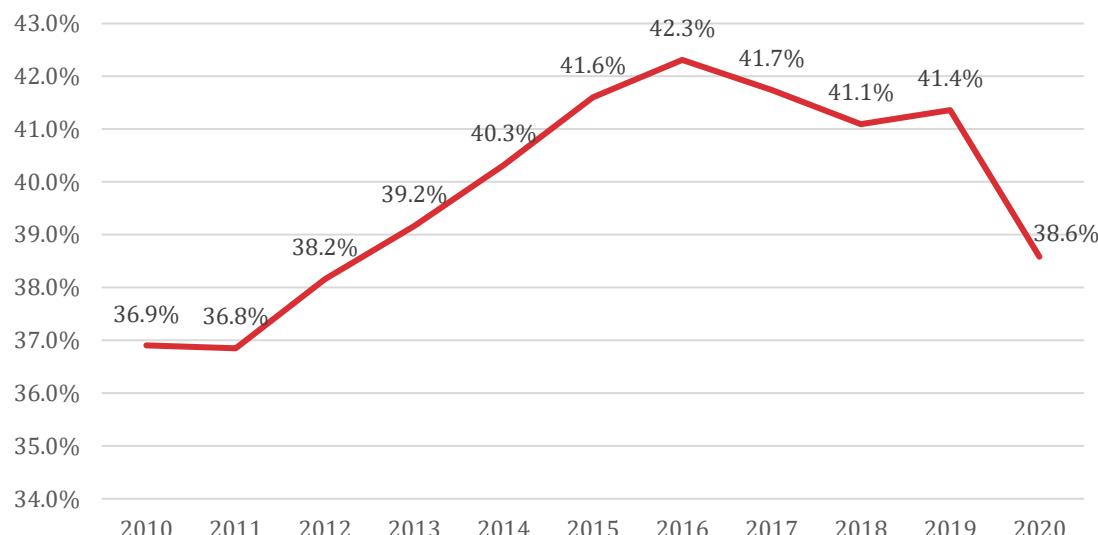
Source: NBS ©CBBC

¹ [Chinese] http://www.gov.cn/xinwen/2021-03/13/content_5592681.htm

² [Chinese] <http://www.gov.cn/zhuanti/2021lhfgzbg/index.htm>

Even before the Covid outbreak, China's efforts to turn domestic consumption into the country's main growth driver were stalling. At the beginning of the 2010s, total retail sales accounted for 36.9% of China's GDP. The share increased in the first half of the decade, reaching 42.3% in 2016. Since then, however, retail sales have lost ground, dropping back to 2012 levels last year.

Graph - China's Household Consumption as Share of GDP (2010-2020)



Source: NBS ©CBBC

Main challenges

To reverse this trend, the Chinese government needs to tackle three deep-rooted problems.

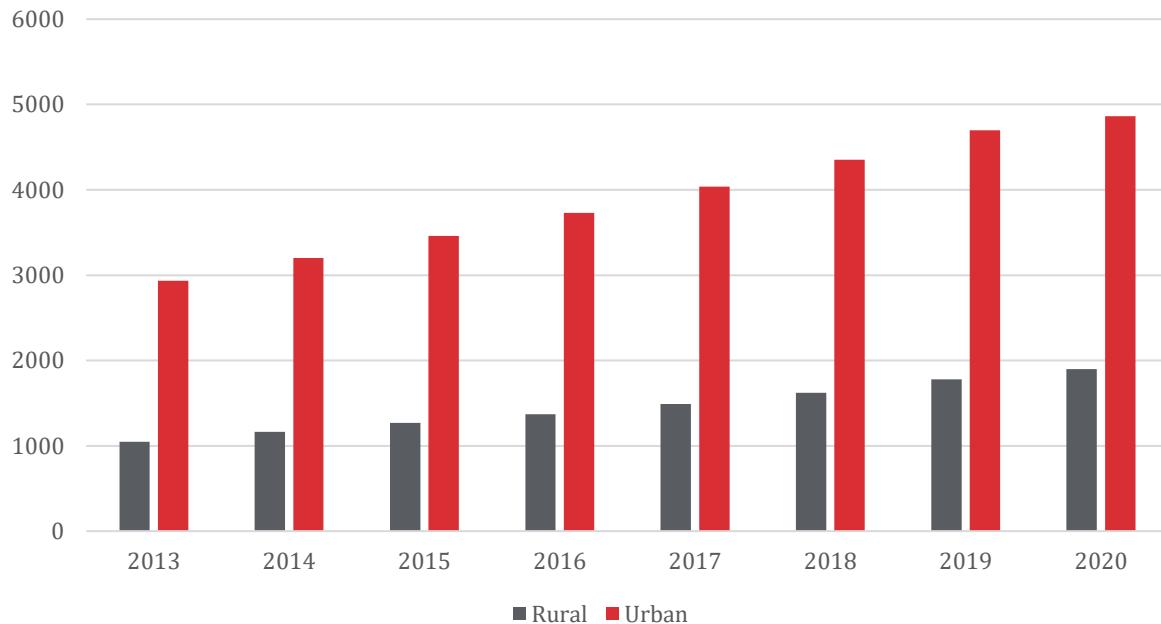
Problem 1: Urban-Rural Divide

The first issue is the persistent divide between rural and urban incomes³. In 2020, the average disposable income of rural households was still 61% lower than that of urban households. As a result, the nearly 40% of Chinese people who are still living in rural areas account for only 22% of aggregate household consumption.

Even though the gap has slightly narrowed over the last couple of years, the reduction in the discrepancy only came at a rate 0.5 percentage points per year. At this rate, it would take over 120 years for rural households to catch up with their urban peers.

³ <https://www.caixinglobal.com/2021-03-26/in-depth-chinas-long-march-to-become-a-consumer-driven-economy-101680899.html>

Graph – Average Disposable Income of Rural and Urban Chinese Households 2013 – 2020 (in £)



Source: NBS ©CBBC

A simple way to increase the spending of rural Chinese would be to allow them to move to urban areas. Yet China's restrictive household registration system – the Hukou system – has barred many migrants from accessing urban welfare, education, and most importantly: real estate.

Although 60.1% of China's population are counted as urban residents, only 44.4% have a hukou. Granting these 16% - around 230 million people – the same rights as hukou-holders could boost urban consumption by 27%, according to Cai Fang, the director of the Institute of Population Studies at the Chinese Academy of Social Sciences ⁴.

Hukou reform has thus become a key element of the 14th Five-Year Plan. The Chinese government plans to remove all hukou restrictions for cities with less than 3 million registered residents, and lower barriers for municipalities with a population between 3 and 5 million people. Only six mega-cities – namely Beijing, Shanghai, Tianjin, Chongqing, Guangzhou, and Shenzhen – would keep their restrictions in place.

Problem 2 – Education

A second problem which keeps consumption levels down is lack of education. Although China is churning out nearly 9 million college graduates per year ⁵, the overall share of people with higher or even secondary education in the country's workforce is surprisingly low.

As the Stanford economist Scott Rozelle has pointed out in his recent book 'Invisible China' ⁶, only 12.5% of China's

⁴ [Chinese] <http://www.chinareform.org.cn/2020/0928/34203.shtml>

⁵ http://www.xinhuanet.com/english/2019-10/31/c_138518625.htm

⁶ Rozelle, S. (2020), *Invisible China. How the Urban-Rural Divide Threatens China's Rise*, Chicago: University of Chicago Press

working age population had a tertiary education in 2015. This is not only far below the OECD average of 34% but even lower than the level in other developing countries like Mexico (16.4%) or Brazil (14.7%).

Although a high school education is much more common – especially in urban areas where it was 93% in 2015 – it remains stubbornly low in rural areas: only 30% of rural workers have ever visited a high school.

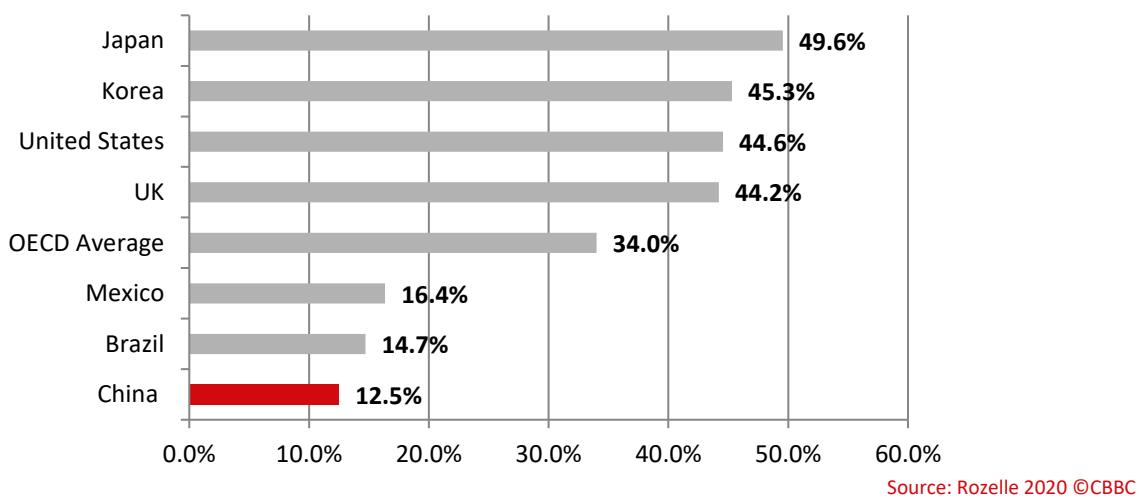
Raising these education levels is crucial if China wants to raise income levels and achieve high-income status. Unfortunately, improving education levels is more difficult than just expanding coverage of urban welfare protection, and requires many years to implement.

The 14th Five-Year Plan has set a target for the average working-age Chinese to have 11.3 years of education. This is half a year longer than the current level of 10.8 years. Allowing more children with rural hukous to attend urban schools could be another way to improve educational levels. In 2015, only 30% of Chinese children had an urban hukou.

The Chinese government also wants to improve its vocational education sector. Inspired by the German model of 'dual education', which combines in-class teaching with on-the-job training, Chinese officials have touted vocational schools as a way to improve educational levels for non-urban high-school graduates as well as migrant workers and veterans. 70% of new entrants into China's manufacturing sector and new service industries already come from vocational schools⁷. In the next five years, the government wants to establish 200 new high-level vocational schools, offering more than 600 specialised majors. It also wants to set up over 100 training bases in cooperation with industry partners.

Yet adding new vocational schools alone might not be enough. In fact, the number of vocational schools in China has actually declined from over 14,400 in 2009 to around 10,000 in 2019⁸. Many existing schools suffer from low enrollment and poor quality. In 2019, a vocational school in China's northern province had to close after it was found to have issued 'fake degrees'⁹. Better supervision, standardization, and stricter quality control will therefore become more important.

Graph – Share of Chinese Working Population with Tertiary Education in 2015



⁷ <http://www.chinadaily.com.cn/a/201902/19/WS5c6c0593a3106c65c34ea2ed.html>

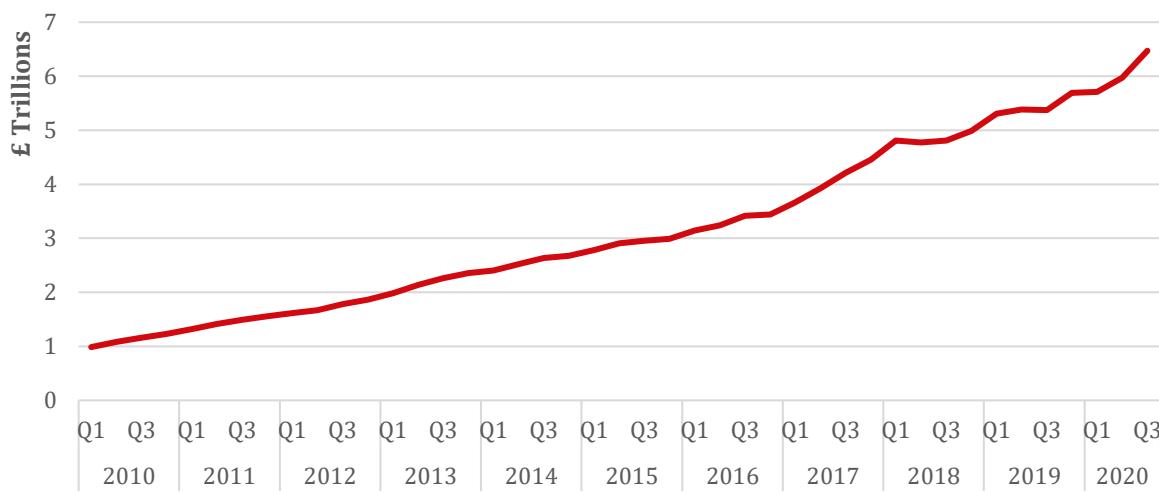
⁸ <https://www.statista.com/statistics/227076/number-of-vocational-schools-in-china>

⁹ <http://www.sixthtone.com/news/1004486/the-chinese-students-stuck-in-fake-majors>

Problem 3 – Consumer Debt

A third and relatively recent problem is China's ballooning household debt. By the third quarter of 2020, Chinese household debt had reached £6.5 trillion, up from £5.7 trillion at the beginning of the year. China's household debt-to-GDP ratio was 61.1%, according to data from the Bank for International Settlements (BIS).

Graph – Chinese Household Debt 2010-2020 (in trillion £)



Source: BIS ©CBBC

While this ratio is still lower than that of many advanced economies – the UK's ratio, for example, is 88.9% -- it is nonetheless starting to affect Chinese consumer behaviour. Jing Daily, a website focused on luxury retail in China, has already warned that growing household debt could lead to a sharp drop in demand for high-end consumer products¹⁰. Younger middle-class Chinese are already changing consumer habits and are embracing second-hand goods¹¹. A McKinsey study from May 2020 also found that up 30% of Chinese consumers would not return to pre-pandemic levels of consumption and continue to spend less¹².

Yet reducing the household debt level won't be easy and will require caution and long-term strategies. For example, soaring real estate prices are a key driver of private debt but putting effective brakes on housing bubbles could easily backfire. A sharp drop in housing prices would lead to a wave of mortgage defaults, ruining the finances of many Chinese middle-class families. With the majority of private wealth now tied up in real estate, China is effectively locked in a vicious cycle in which rising real estate prices keep both lenders and borrowers solvent.

¹⁰ <https://jingdaily.com/china-debt-crisis-disposable-income-luxury/>

¹¹ <https://www.reuters.com/article/us-health-coronavirus-china-consumption-idUSKBN22G09C>

¹² <https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/cautiously-optimistic-chinese-consumer-behavior-post-covid-19>

CBBC View

The Chinese government is clearly aware of these challenges. Yet addressing them will require careful and potentially painful reforms.

Granting more Chinese access to urban hukous is certainly the easiest reform to address these problems. But even this will require more support for local governments, which, so far, have been reluctant to share scarce resources with non-registered residents. Opening schools, hospitals, and other municipal facilities to migrant workers could also trigger a backlash from local residents, who are often unwilling to share these resources with new entrants.

Improving education levels is more difficult, not least because it takes at least a decade to train an educated workforce. Relying on vocational training courses for older workers might provide a solution but will require better oversight and clear quality standards to ensure that graduates can compete in a high-income labour market.

Reducing household debt is the most difficult challenge. Ultimately, only when household income rises faster than expenditure – especially those for real estate – can China hope to keep private debt levels under control. This will require higher productivity levels and the creation of better paying jobs. Unless this happens, household debt will continue to increase.

CBBC is paying close attention to the development of China's consumer market. If you like to know more about the latest trends, please sign up to our **UK-China Consumer Week 2021** which will shine a spotlight on China's consumer market recovery and call attention to opportunities for UK brands to re-engage with China. This unique programme will take place online between the **19th and 23rd April 2021**. Sessions will be held over five consecutive days, allowing attendees access to the full event programme. For more information: <https://www.cbbc.org/uk-china-consumer-week-2021>

CBBC is also organising a webinar with **Scott Rozelle**, author of *Invisible China*, on **12 May 2021**. Please visit our CBBC event page for further updates: <https://www.cbbc.org/events> 

About the author



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