China’s surging growth and huge domestic market have long fueled dreams that once its consumers are unleashed rising demand will help heal ailing Western economies. But John Berthelsen argues that while imports and consumption are rising, structural impediments and other factors combine to make it unlikely that the China market will have a significant impact on Western economies in the near term.

Although a long succession of Western leaders, bankers and finance officials have held out the holy grail of the Chinese consumer’s purchase of Western exports as the savior of flagging economies, it may well remain a distant dream.

It is certainly true that China, with an embarrassing $3 trillion in foreign exchange reserves and trade and current account surpluses that amount to 10 percent of gross domestic product, has been seeking to drive up imports. Yu Ping, vice chairman of the China Council for the Promotion of International Trade, told reporters at the Asia Pacific Economic Co-operation forum in Hawaii in November that the current five-year plan is focused on balancing imports and exports. The plan, he said, “demonstrates China’s resolution to improve its status in technological development as well as its determination to leverage the country’s massive domestic market.” As an example of that resolve, Vice Minister of Commerce Zhong Shan said in Shanghai in September that the commerce ministry was considering cutting taxes on imported consumer goods and was soliciting guidelines to encourage more imports. Andy Rothman, the China macro strategist for CLSA in Hong Kong, in a recent report pointed out that China’s share of personal consumption expenditure for US goods has doubled over the past decade, with US exports of electronics, agricultural and other products to China rising by 468 percent from 2000 to 2010.

That said, there are formidable structural obstacles to raising consumer spending in China that could take decades to unravel. Chinese household savings are as high as 50 percent, partly due to the region’s traditional conservatism but also because the country lacks a social safety net. Pensions are almost nonexistent, along with reliable health insurance, either government or private. The education system is equally troubled, to the point where families who want to give their children adequate schooling must send them to private institutions. While the university system is improving, many wealthy Chinese send their children overseas.

Consumers also are cautious. According to government statistics, private household consumption was only 37 percent of gross domestic product in 2009, down from 49 percent in 1990, a fact that is likely best explained by the massive rise in GDP over the period. In the United States, by contrast, household consumption accounts for 70 percent of GDP, including spending on health care by both individuals and government.

Statistics on consumer imports themselves are also problematical. Much depends on the definition of what is an export and what is an import. It is no longer a world where a manufacturer produces a mousetrap in Pekin, Illinois, and sells it in Beijing, China. Galina Hale and Bart Hobijn, two economists for the Federal Reserve Board of San Francisco, in a widely circulated Aug. 8 issue of the board’s Economic Newsletter, use the example of an Apple iPhone; in 2009 it sold for about $500 in the United States and was produced for about $179 in China, the economists found. That ought to mean that $179 of the retail cost consists of China-based content. The other $321 represents US costs, markup, retail rental costs, design and research etc. But Hale and Hobijn found that only $6.50 of that iPhone assembly price was actually due to assembly costs in China. The other $172.50 reflected the
cost of parts produced in other countries besides China — including $10.75 for parts produced in the United States and exported to China.

Across the board, Hale and Hobijn found, “on average, of every dollar spent on an item labeled ‘Made in China,’ 55 cents go for services produced in the United States. In other words, the US content of ‘Made in China’ is about 55 percent. The fact that the US content of Chinese goods is much higher than for imports as a whole is mainly due to higher retail and wholesale margins on consumer electronics and clothing than on most other goods and services.”

It is the same going the other way. Goods stamped “Made in USA” don’t necessarily come from the United States. For instance, one of the country’s biggest export categories to China in 2010 was aircraft, at $5.6 billion. But only 70 percent of the parts for the 787 Dreamliner, Boeing’s newest-generation aircraft, were produced in the United States. The other 30 percent came from the 70 operations the plane-maker has outside the country. Thus, while America swells with pride over its homegrown Boeing, at least 30 percent of the manufacturing jobs are elsewhere.

Undeniably there is some scope for encouragement. While China’s exports continue to rise, imports have been surging as well — by 28.7 percent annually in November 2011 following a 20.9 percent year-on-year jump in September. “Ordinary trade imports accelerated to 39.8 percent year-on-year in October from 31.5 percent year-on-year in September, although processing imports rose by only 8.9 percent year-on-year in October,” according to a Nov. 10 report by Qu Hongbin, chief China economist for HSBC. “Imports of major commodities were generally resilient in volume terms.”

Much of that, of course, is in commodities including iron ore, steel, crude oil and unwrought copper. But China is now the world’s third-largest importer overall and, even stripping out energy and other commodities, there is a lot of activity. Foreign car companies — all of them partnered with domestic makers — hold about 85 percent of the Chinese car market, with General Motors the No. 1 auto maker, selling a record 2.35 million units in 2011, far more than it sold in the US domestic market. That figure is expected to climb in 2011, although the pace of sales has slowed as China’s economy cools. The company sold 620,000 units in the third quarter of 2011, up 9.3 percent year on year.

Following GM at No. 2 is Volkswagen. Mercedes-Benz, Ford, General Motors, Suzuki, Daihatsu, Honda, Subaru, Citroen and Toyota all have plants in China. There are now 45 million cars on China’s roads, a three-fold increase from 2000. Caterpillar, the world’s biggest construction equipment manufacturer, has 16 manufacturing facilities, three R&D centers and three logistics and parts centers in China. But how much comes from the Caterpillar headquarters in Moline, Illinois, is unknown.

IT’S ABOUT THE BRAND
Sales of imported Nike and Adidas sport shoes have been growing 20 percent annually. China is the fastest-growing market for the iPhone, with a 250 percent annual increase in the second quarter of 2010, compared with 155 percent growth in the United States. Chinese consumers are partly in love with Western products and partly extremely cautious about their own, perceiving quality to be poor and sometimes outright dangerous.

Two surveys released in November, one by McKinsey & Co. and the other by Synovate Global Market Research, excitedly point to an increasingly sophisticated consumer class in China that is beginning to adopt foreign tastes, particularly in food and other consumer imports. The Synovate study quotes Chinese Customs statistics that show that in the first five months of 2011, China’s food import and export values totaled $35.09 billion, up 36.2 percent year-on-year. China, the study says, is now forecast to be the top market for US agricultural exports by the end of 2011 at $20 billion, surpassing Canada at $18.5 billion.

McKinsey & Co., in its November quarterly report, titled “China’s Confident Consumers,” says: “The Chinese have taken to consumerism with ease, embracing thousands of new products, services and brands.” Even in the face of rising inflation, the study says, Chinese consumers are more confident this year than in 2010 about their financial prospects, although among urban consumers, the number of first-time buyers — a group that has been a major driver of category growth in China — is declining.

There is no letup in the influence of brands on Chinese consumers’ buying decisions, the McKinsey report says. “But neither does it indicate strong signs of increasing loyalty to any single brand.” The survey shows the extent to which consumers value brands more than price, largely...
because they believe that branded products are safer, of higher quality and more reliable than non-branded ones.

Within the general trend of rising consumerism, according to Synovate, “is the increasing consumption of western food and drink products by Chinese consumers.” This is driven in part by the increasingly easy access to imported products, often via internationally branded supermarkets and groceries. Wal-Mart as of May had 338 outlets in 124 Chinese cities, with 90,000 employees and annual sales of $7 billion.

**FOOD SAFETY WORRIES**

Continuing issues over food safety have played a role, with consumers suspicious of domestic producers in the wake of the melamine scandal of 2008, in which some of the country’s biggest milk producers were found to have added melamine to milk and infant formula, causing an estimated 300,000 people to fall ill, with at least six children dying of kidney damage. In a separate incident four years earlier, watered-down milk resulted in 13 infant deaths from malnutrition. (Wal-Mart, however, didn’t help its own case when in October it had to own up to the fact that it was forced to pay 1.60 million yuan because 10 of its Chongqing stores were fraudulently selling ordinary pork as organic pork. Wal-Mart, according to the government, has been punished 21 times since 2006 for exaggerated advertising and selling expired or substandard food.)

Consumers, according to the Synovate study, also seem to be more willing to “put their money where their mouth is—as long as the taste component is acceptable—to spend more for healthier alternatives.” It quotes a 2010 survey by Global Intelligence Alliance of 67 Asian consumer and retail industry professionals in China, India and Southeast Asia in which 70 percent of respondents said Chinese consumers have become more willing to pay more for better quality food and beverages over the last 12 to 18 months. While some speculation ensued that the temporary shock in demand would subside, two years after the infant formula melamine scandal, consumer preferences seem to have permanently switched to international and premium local brands over cheaper local options.

Western fast food brands, particularly the KFC fried chicken chain, which first opened in Beijing in 1987, followed shortly by McDonald’s, have been thriving. The Louisville, Kentucky-based Yum! Brands, which owns KFC, said in its third-quarter results that China was responsible for 35 percent of revenue growth and estimated that it would open 600 new units in China this year. Yum! expects an estimated $2 billion in operating profit in 2011 from 3,700 restaurants in China. Same-store sales grew at a 19 percent annual clip, compared with a 3 percent decline in the United States. Although local fast food brands like Kungfu, Yonghe King, Da Nang Dumpling and others still dominate the sector with 70 percent market share, Western brands are catching up.

Fast food brands are rapidly expanding beyond the so-called Tier 1 cities of Beijing, Shanghai and Guangzhou to second and third-tier areas, Synovate’s report said, “bringing Western tastes to Chinese palates on an unprecedented scale.” They are aided in their efforts by the profusion of American and European food and drink manufacturers, who are also getting a much broader range of tastes and flavors within easy reach of Chinese consumers.

Dangerously, Chinese sugar consumption has risen by 48 percent over the last decade, according to the US Department of Agriculture, with sweet beverages a significant and growing source of sugar consumption. “Data from Swire Pacific, a major soft drink distributor, show that soft drink sales in its sales areas rose five-fold on average between 1999 and 2009 compared to 7 percent growth in the US over the same period,” the McKinsey survey said.

**RAISE A GLASS**

The Chinese have also become formidable wine drinkers, and rather quickly. According to Synovate, a recent study conducted by VisaCard Worldwide based on a survey of 1,800 respondents with an annual income exceeding $16,000 in Beijing, Shanghai and Guangzhou, found that 80.7 percent prefer French wine, followed by Italian, then Chinese brands ahead of Spanish, Australian and German ones. The study quotes Meininger’s Wine Business International, which predicts that Chinese wine consumption overall will increase 70 percent by the end of this year, making China the eighth biggest consumer of wine in the world by 2012. Domestic wine sales have seen an average increase of 20 percent in recent years, against an international growth rate of just 1-2 percent.

China’s demand for coffee also is growing by an estimated 15 to 20 percent a year against a world average of around 2 percent, and is expected to reach 300,000 metric tons annually by 2020. Coffee sales currently account for a little over 20 percent of the hot drinks market in China, compared to around 70 percent for tea. According to Synovate’s Media Atlas China survey, nearly one in 10 Chinese consumers in Tier 1 cities visited a coffee shop at least once a month or more. From its first store in 1999, Starbucks now operates 450 stores and plans to triple that number by 2015. The demand is actually causing tea planters in China’s southwest to switch to growing coffee beans.

No doubt reflecting this confidence, McKinsey says, the number of respondents who choose to spend more—buying in greater quantities, more frequently or more expensive items in a given category—is holding firm. Whereas last year’s survey showed that consumers offset higher spending in some categories by spending less in others, this year there appears to be much less rebalancing.

Also noteworthy is how consumers who spent more in 2010 than in 2009 account for their higher spending. On average across categories, half of the survey participants identified inflation as the main reason. But of the remainder, 35 percent said they were trading up—buying more expensive goods in a given category—an increase from 26 percent in last year’s survey. Sixty percent said that buying in larger quantities or more frequently was the main reason for higher spending, compared with 54 percent in last year’s survey.

But only 5 percent of consumers said they were spending more because they were first-time buyers in certain product categories, down from 20 percent in last year’s survey, an indication of the growing maturity of many categories.

But despite the Synovate and McKinsey numbers, which look promising, taken in aggregate, they don’t boost exports enough to make a serious dent in the US balance of payments problem. It is a massive hill to climb. Through September, the US trade deficit with China was about $217 billion, compared to $202 billion for the same period a year earlier. It is on pace to surpass last year’s record $273 billion deficit.

So the picture is far from clear—imports and demand in China are rising but not in ways that are going to cure the ills of ailing Western economies. As People’s Bank of China Governor Zhou Xiaochuan said recently, boosting the nation’s consumer spending to redress global imbalances is “easier said than done.”

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