There has been much talk recently about stimulating private consumption in China, which is seen by a growing chorus of policy makers and analysts worldwide to be an important means of reducing China’s growing external surplus.

This discussion runs the risk, however, of prompting a string of ad hoc policy actions that could provide temporary relief, but no lasting solution to fundamental imbalances in the Chinese economy.

The real issue in China is how to rebalance the economy away from heavy dependence on exports to lead growth towards self-sustaining domestic demand, including a substantial improvement in the efficiency of investment.

The recently announced revisions to the national accounts may make the levels of key macroeconomic ratios in China look more reasonable, but the basic story will remain much the same: Gross national saving in China amounts to more than 40 percent of gross domestic product, suggesting that Chinese households are very frugal.

Things are not quite that simple, however. As companies have improved their performance, corporate saving has risen and now accounts for almost half of national saving. Corporations have an incentive to retain their earnings in order to self-finance their investment.

This is particularly true for private sector companies, which have limited access to bank financing and few domestic alternatives for raising money. State-owned enterprises that do make profits are generally not required to pay dividends to the government, and these companies naturally prefer to retain their earnings and plow them back into new investments.

By some measures, Chinese households have in recent years saved almost a third of their disposable income. One would expect a lower saving rate in an economy that still has a relatively low per capita income and, more importantly, good prospects for continued high income growth.

So why do Chinese households save so much of their current income? Research under way at the International Monetary Fund using household-level data from China provides some clues.

The precautionary motive for saving is very strong among Chinese households because of the lack of an adequate pension system and the sharply rising costs of health care. Demographic factors add to this saving motive: The one-child policy instituted in the 1970s to control population growth has intensified the aging of China’s population. The need to finance education expenses has also bolstered saving.
The slow development of financial markets in China has meant limited availability of credit, so that households generally have to save in order to purchase big-ticket items, like houses and cars, rather than being able to borrow against future income. It also has meant that there are low returns on households' financial assets and limited opportunities for portfolio diversification, since there are few alternatives to depositing savings in state-owned banks.

All of this suggests that financial market reform and development is a key priority, which the Chinese authorities recognize.

Enterprises might be less compelled to rely on internally generated funds if they could count on a broader set of financial markets to generate capital. Increased access to credit for households, the availability of a wider range of saving instruments that would help them to diversify risk, and higher returns on their assets also could contribute to a reduction in household savings.

Thus, building a broader-based, well functioning financial market would help to rebalance China's economy by tilting domestic demand growth away from heavy reliance on investment toward consumption.

Exchange-rate flexibility could also have a role by providing more scope for monetary policy independence and helping cushion the economy from economic shocks. It could also contribute to rebalancing the economy by improving investment decisions, and a likely appreciation in the near term could raise consumption by bolstering households' real incomes.

The government also has a major part to play in influencing saving and consumption, particularly through provision of education, health care and pensions. Reducing uncertainties in these areas could substantially diminish the strong precautionary saving motive among Chinese households and give them the confidence to raise their consumption.

The bottom line is that, rather than look for short-term fixes for increasing private consumption, the focus should be on structural reforms that would stimulate a more permanent increase and make GDP growth more balanced over the medium term.

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