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What is behind China's high savings rate?

Sean Dougherty

China's national savings rate now stands at over half of its GDP, an extraordinarily high rate that has been rising in recent years. What lies behind this high rate of savings? Misconceptions abound.

It is not, contrary to popular belief, simply a result of highly cautious households saving at an extraordinary pace due to the lack of a social safety net. In fact, the household savings rate, while high (at about 17% of GDP), can be mostly explained by demographic factors and future earning potential, consistent with Nobel laureate Franco Modigliani's Life-Cycle Hypothesis, which has been shown to hold for many OECD countries as well. Moreover, China's household savings rate has increased at most 2 percentage points in the past five years, as China's demographic dividend has peaked. Yet the overall savings rate has likely increased by 10 percentage points over the same period.

Surprisingly to most people, the largest contributor to the high and rising savings rate in China is actually corporate sector savings, or the retained earnings of companies. These are excess profits that companies do not pay out as dividends, but rather hold pending future investment opportunities. This size of this corporate savings is extraordinary – estimated at about one-third of GDP – having risen markedly as corporate profits have grown from the trough in the late 1990s. Profitability in the private sector has been particularly impressive, and now exceeds a 20% rate of return on assets, well above the OECD company average. In most economies, such earnings would be paid out as dividends, and companies would seek additional financing from capital markets or banks. But in China, the capital markets have given very little access for private sector companies to the equity or bond markets, and bank financing can be hard to come by for young companies.

Perhaps even more remarkable than the large contribution of the corporate sector to China's national savings is the role of government savings. While it has not been as large a contributor to national savings as corporate retained earnings or household savings, government savings has actually increased over the past five years by about 2 percentage points, such that the government now runs a fiscal surplus (of about 1% of GDP). Such a conservative fiscal policy despite China's low debt level is extraordinary, as a country with China's rate of growth could run a moderate deficit and not increase its debt burden at all. Alternatively, it could give substantial tax breaks. While the government has considered increasing social expenditure, such as by developing a comprehensive public health system, little expenditure has been devoted to such ends so far.

High national savings has funded a rise in China's current account and trade surplus, which has ballooned from being a negligible share of GDP to double-digit levels in the past five years. This development has exacerbated trade frictions and lead to calls for protectionist measures from some OECD countries, due in part to the simultaneous rise in China's exchange rate reserves, which can suggest an overvalued currency. Greater flexibility of the exchange rate, which would likely lead to more rapid appreciation of the Renminbi, could help to resolve these imbalances, as would a more liberal fiscal policy, which could aid in offsetting the contractionary effects of an appreciation. Finally, financial market liberalization that gave greater access for private companies to capital markets would help as well, by reducing companies' dependence on retained earnings for investment.

(The author is an economist in the OECD's Economics Department. These views are personal.)