What Makes Mr. Zhang Save?

Why are the Chinese such legendary savers? The answers shed light on why that habit is about to change.

BY MICHAEL PETTIS

In the annals of thrift, few feats rival the accomplishments of China, Japan, and other East Asian nations during the past 30 years. China's workers and institutions now bank some $2.5 trillion a year, just over half their total income, while their Asian counterparts put away nearly as much, creating a vast pool of savings that has transformed the global economy. While the sons and daughters of the middle class and the rich throng China's many malls to window-shop, their poorer peers, as well as their parents and grandparents, still salt away a large share of their weekly paychecks.

The easiest and probably most widely accepted explanation for what looks like extraordinary self-discipline is the power of Confucian culture. That explanation makes a certain sense—East Asian immigrants in the United States are also famously thrifty—yet there is not as much to it as one might think. For much of China's history, the Confucian culture was actually considered inimical to both the accrual of savings and rapid economic growth. As far back as the fifth century BC, critics bewailed the laziness and spendthrift ways of the Confucians. The philosopher Mozi (ca. 470–ca. 391 BC) complained that the Confucian

> turns his back on what is basic by refusing to work, and contents himself with laziness and arrogance. . . . In the summer he begs for grain, but once the harvest is in, he goes chasing after big funerals. All his children follow him there, to eat and drink their fill. If he can manage a few of these, it will be enough to get by. . . . When a wealthy family requires a funeral, he is delighted. "Here," he says gleefully, "is the spring from which food and clothing flow!"

Two and a half millennia later, in the 1950s and early '60s, many Western sociologists and economists agreed with Mozi. The puzzle then was to explain East Asia's desperate and seemingly invincible poverty. Drawing on Max Weber's portrait of the building blocks of capitalism in *The Protestant Ethic and the Spirit of Capitalism* (1905), they confidently explained that Confucian notions of family, morality, and prestige made the systematic creation of wealth through business and technological inno-

Michael Pettis is a finance professor at Peking University and a senior associate at the Carnegie Endowment for International Peace.

vation almost impossible in East Asia. Confucian spending patterns, especially the expensive rites and burial customs associated with ancestor worship, also made it difficult for Chinese households to accumulate enough wealth to fund capitalist enterprises.

Yet by the 1980s, when Japan and the Asian Tigers were suddenly riding high, analysts had no difficulty arguing that it was precisely the Confucian characteristics of these societies that explained their success. Confucian ideals of harmony between government and business interests and Confucian concerns with honesty, probity, and responsibility—like Quaker beliefs in 18th-century England—had created the foundation for a thriving business culture. Then came the 1997–98 Asian financial crisis. The old arguments about the handicaps of Confucian culture, especially the contention that "harmony" is often little more than a euphemism for corruption, made a temporary comeback.

IN THE UNITED STATES, people tend to save less when interest rates are low, but in China and many other Asian countries, the opposite is true.

Confucianism, in other words, is too flexible an explanation for Asian development if it can account for poverty as easily as it explains wealth. And it is very clear that other factors play a major role in making the Chinese and other East Asians such prodigious savers. Some of these factors are beyond the direct influence of policymakers. It is an established pattern in most poor countries that begin experiencing rapid economic growth that spending on furniture, clothing, motorbikes, televisions, and other consumer goods rarely grows as quickly as income. The surplus goes into savings. That is precisely what has happened in China, where savings have risen from 20 percent of the gross domestic product in 1981 to more than 50 percent today. (In recent years, the most rapid growth has not been in household savings but in corporate savings.)

Demographic trends are another more-or-less intractable influence on savings. Since the mid-1970s, China's working-age population has grown at a much faster pace than its population as a whole. In effect, this at least partially explains why production has increased faster than Chinese society's ability to absorb what it produces. The result: The savings rate has increased. But this demographic trend will reverse in the next four or five years, as the smaller cohorts created by China's one-child policy come to the fore and the country's working-age population begins to contract much more rapidly than the total population. As this happens, Chinese consumption should begin to catch up with and perhaps even outpace Chinese production.

It is also often said that the Chinese save so much because a big bank account is the only insurance they have against medical disasters, periods of unemployment, and retirement needs. The government has publicly stated its urgent desire to provide a medical safety net, but for now Chinese families are on their own when it comes to covering medical bills, and the popular press is full of horror stories of bedridden patients forced to leave hospitals when their payment accounts, which patients typically must open at hospitals before being admitted, run out of money. But there are limits to this explanation. Many other developing countries with spindly social safety nets have low savings rates, while Japan in the 1980s had strong supports and very high savings rates at the same time. Although China's leaders claim to be eager to create a social safety net, even if they succeed it will be many years before ordinary people trust the system enough to reduce their savings commensurately.

In addition to all these difficult-to-control factors that influence thrift, there are significant policies that governments in East Asia have explicitly or implicitly designed to constrain consumption and boost savings. These policies, many of them directly or indirectly related to industry and trade, have probably had a much bigger impact on savings than many observers recognize. This is because any policy that causes production to grow faster than consumption must necessarily also boost the trade surplus and the domestic savings rate.

For example, the People's Bank of China, whose responsibilities include setting base lending and deposit rates for all the institutions in the banking system, has kept interest rates much lower than what we would normally expect of countries at China's stage of development. The goal has been to provide cheap capital for investment in domestic manufacturing, and the government has succeeded so well that, not surprisingly, it has fostered the misallocation of capital on a huge scale. China's banks are weighed down with bad loans they never would have made if capital wasn't so abundant. The need to protect bank profits from these mistakes has given regulators strong incentives to guarantee those profits by keeping the rates available to depositors even lower than the low corporate lending rates.

China's workers and institutions salt away more than half of their total income, some $2.5 trillion a year.

As a result, China's Joe Sixpack—call him Mr. Zhang—earns tiny returns on his savings. Demand deposits are currently capped at 0.36 percent a year, while three-month CDs return a measly 1.71 percent. For the past several years rates have been at best just a few percentage points more, even as inflation peaked at more than eight percent.

In the United States, people tend to save less when interest rates are low. A decline in rates usually goes hand in hand with an upswing in real estate, stocks, and other investments, making Americans feel richer and less inclined to check off a hefty 401(k) paycheck deduction.

But in China and many other Asian countries, low rates seem to have the opposite effect. One reason is that few Chinese have the financial wherewithal to make stock or real estate investments (and the Chinese stock market is minuscule relative to the economy), and so most people must keep their savings in bank accounts, where they eke out meager gains. Low interest rates don't simply make Chinese savers feel poorer; given the large amount of bank savings, interest income is a significant fraction of total household income, so low or even negative real interest rates (after the effect of inflation is deducted) make them poorer in fact. Thus, even as low-interest-rate policies slow consumption growth, they boost production by subsidizing loans to manufacturers. The result: a burgeoning trade surplus and soaring savings.

There are other trade- or industry-related policies that affect savings. China and many other East Asian countries are well known for keeping the value of their currencies low in order to promote exports, but these policies also have the effect of increasing savings. If the Chinese yuan is undervalued by 30 percent, as many economists believe, this has the same effect on prices as, for instance, increasing the cost of an $89.99 Samsung mobile phone to $119.99. No wonder Chinese consumers are wary of imports. The high cost of imported goods lowers the real value of household income and so reduces the incentive to buy consumer goods. It also boosts production by making exporters more profitable. As production outpaces consumption, the savings rate, which is the difference between the two, rises.

In general, we tend mistakenly to assume that only exchange-rate and tariff policies are trade-related policies, but in fact any policy that affects the gap between what is produced locally and what is consumed locally is implicitly a trade policy and also implicitly affects the savings rate. In that sense, the whole Asian development model can be seen as one whose policies are aimed directly at boosting savings and channeling them into investment.

This model is about to undergo serious change, and with it we can expect Asian savings rates to decline sharply. For the past 30 years, this model has been very successful in creating the conditions for rapid economic growth in the East Asian countries, but the consequences for the rest of the world have not been completely benign. It is a fact of economic life that when one part of the world produces more than it consumes, another part of the world must do the opposite. If this does not occur, the world must adjust, usually through a slowdown in growth. The high and rising savings rates that are encouraged in Asia, in other words, require that another part of the world experience low and declining savings rates.

For the past three decades, and especially since the turn of the 21st century, the United States has played the role of chief global consumer. American savings rates declined precipitously as those in Asia rose, and although economists argue ferociously about which change caused the other, no one doubts they are linked. That ineluctable connection is the reason why all of our assumptions about Asian savings rates are likely soon to be rendered obsolete.

One of the main causes of the current global economic crisis was the frenzied and unsustainable borrowing of Americans eager to continue their consumption binge. Now U.S. households must repair their tattered balance sheets. This they can do only by cutting back on consumption and saving more. But as American savings rates rise (which they have already done to a remarkable degree in just the past few months), there must be an offsetting adjustment elsewhere in the global economy. Americans simply are not going to be buying as many goodies as they once did.

That "elsewhere" is very likely to be Asia. In China and other Asian nations, savings will decrease as people either spend more of their money on goods and services or suffer a decline in income as industries that once exported goods to free-spending Americans shrink. The most likely outcome is a combination of the two. The streams of unemployed workers heading back to their home villages from the shuttered factories of Wenzhou and Guangzhou suggest that without an almost impossibly large boost in Chinese consumption, factories will stay closed for many more years.

No matter which path Asia follows over the longer term, the change in U.S. household behavior spells the end of the development model that has for several decades defined the policies of rapidly growing East Asian countries. If China makes the transition successfully, a decade from now we will be asking ourselves not why the Chinese save so much, but how people in such a poor country can afford the BMWs, fancy clothes, and Napa Valley wines they buy with such abandon. If China does not make a successful transition, Chinese consumers won't be spending much, not because of their impossibly high savings rates but because of their country's very slow economic growth. Either way, we are about to see a change in the legendary savings habit. ■