**Economy: Consumption and Investment are Both Important to Current Chinese economy: Are the Suggestions by Krugman and Yellen Proper?**

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　　On April 4, U.S. Treasury Secretary Janet Yellen visited China and pointed out China’s “overcapacity” problem, attributing it to a series of “production-supporting” industrial policies that the Chinese government has long implemented. Coincidentally, on May 24, American economist Paul Krugman wrote in the [New York Times :](http://quote.eastmoney.com/unify/r/106.NYT)” published an article saying that the world today is suffering from the “second China shock” and claiming that “the most obvious solution to the current difficulties of the Chinese economy is to shift from the production end to the consumption end.”

　　As a Nobel Prize winner, Krugman is undoubtedly a big-name economist. Yellen, who serves as Treasury Secretary, was also a professor of economics at many universities. But the prescriptions they prescribe for the Chinese economy are questionable. The author believes that simply "turning to consumption" implies the judgment that "consumption, rather than investment, is more important to the current Chinese economy", which directly separates and even opposes consumption and investment. In addition, the views of these two representative figures are based on the actual needs of topics such as the operation of the US economy, policy choices and even the general election. This article will analyze from three aspects: theory, history and policy to illustrate that consumption and investment are equally important in the current Chinese economy.

　　**Theoretical Debate**

　　Basic economic concepts such as consumption and investment are important economic categories in both Marxist political economics and Western economics. To avoid falling into a contextual dispute, we use the most consistent system, the National Accounts System (SNA) widely used by market economies, and start with the statistical indicators under the national economic accounting system that are not controversial.

From the perspective of expenditure accounting, economic growth is the sum of three demands: consumption, investment, and net exports. Therefore, economic researchers often compare final consumption expenditure, total capital formation, and net exports of goods and services to the "three horses" that drive economic growth. Final consumption is divided into two categories: household consumption and government consumption, which refers to the value of goods and services used to meet the personal needs of residents and the public needs of social members in the current period. The most commonly used indicator for measuring household consumption is the total retail sales of consumer goods (social retail), which includes goods used by individuals for daily consumption and goods used by social groups for non-production and non-operation.

Capital formation refers to the final product used for asset accumulation. From the accumulation results, capital formation corresponds to the net change in production assets caused by economic transactions in the current period, that is, investment expenditure spent on the accumulation of production assets. Production assets include fixed assets, inventory, and valuables. The purpose of capital formation is to increase future production capacity, but it also faces effectiveness issues. Not all capital formation reflects the active accumulation of various economic units.

Capital formation may be passive holding of goods and services. In this case, capital formation is invalid, that is, there is a difference between effective investment and ineffective investment. Currently, China’s investment is divided into two categories: government investment and corporate investment. The former mainly involves infrastructure construction, public services, green environmental protection and other fields, while the latter is corporate investment in production, R&D and other fields.

However, when using the two concepts (indicators) of consumption and investment, there is an important distinction, namely the time limit. A common saying in economic analysis is to look at operations in the short term and growth in the long term; further, even in the short term, it is necessary to distinguish between normal operation under normal conditions and emergency management under crisis conditions.

**Keynes, Böhm-Bawerk and Schumpeter**

　　Here, we will continue to use the classical Western economics theory and review our existing understanding of the economic mechanism of the two.

In the 1930s, Keynes, faced with the depression of the British economy, proposed three basic laws, namely, the decreasing marginal propensity to consume, the decreasing expected marginal rate of return on capital, and people's liquidity preference to explain it. He believed that due to the decreasing marginal propensity to consume, with the expansion of production scale and the increase of national income, the proportion of consumption (referring to residents' consumption) in the national economic system will gradually decrease, and insufficient effective demand will always occur. Because of the existence of the decreasing expected marginal rate of return on capital, entrepreneurs are unwilling to make additional investments in the market where production capacity can already meet demand, resulting in an oversupply of savings and lower interest rates, thus causing the economy to fall into recession. During the recession, due to the pessimism of enterprises and consumers, total demand may further decline, leading to a further reduction in output and employment.

At this time, since the market interest rate was already extremely low, it is difficult to improve investment expectations by further lowering the interest rate. Therefore, Keynes advocated increasing consumption through government intervention to alleviate the dilemma of oversupply in the product market, thereby driving investment and reducing unemployment.

Böhm-Bawerk and Schumpeter have conducted detailed analysis on the role of investment in economic growth. Böhm-Bawerk proposed the concept of "roundabout production": in order to achieve economic [growth](http://quote.eastmoney.com/unify/r/116.00001) and a higher standard of living, individuals and manufacturers should adopt a more roundabout production process. "Roundabout" means sacrificing current consumption to produce more capital goods, adopting new technologies, and organizing a longer production process, which will lead to greater consumption. Böhm-Bawerk believed that increasing savings and postponing consumption would not harm business, but would be a more effective form of expenditure. If this part of the savings can be used for new technologies, new business investment and capital formation, it will form future dividends.

Therefore, Böhm-Bawerk believed that capital formation is a necessary condition for economic growth. Schumpeter attributed the fundamental driving force of economic development to innovation, believing that innovation is a kind of "creative destruction", that is, the process of industrial development is a process in which the old economic structure is constantly destroyed and the new economic structure is constantly created. He believed that without innovation, the economy can only be in a state of equilibrium of "circulation", and economic growth is only a change in quantity, not a "economic development" with a qualitative leap. Innovation depends on investment, but it is not an increase in the amount of existing capital, but a "recombination of production factors."

　　Comparing the theories of Keynes, Böhm-Bawerk and Schumpeter, it is not difficult to see that consumption and investment play different roles in the process of economic growth. Increasing consumption is an effective measure when there is overcapacity and downward pressure on the economy in the short term. Increasing investment, especially investment in new technologies and new formats, is an indispensable condition for forming new economic momentum and promoting long-term economic development. When weighing investment and consumption, we should fully consider short-term downward pressure and long-term high-quality development and adopt comprehensive measures.

　　**Lessons from History**

　　Theory comes from practice, and is enriched and improved in practice, and can then be used to guide practice. But the important premise is that theory needs to be tested in practice. Here, we look at the two most important "theory practices" in the United States in the 20th century.

　　One is the Reagan reforms in the early 1980s.

Since the 1970s, the United States has been facing serious economic problems: high domestic government debt, high unemployment and [high inflation.](http://quote.eastmoney.com/unify/r/105.QCOM) In addition, due to competition from Japan and European countries, the competitiveness of domestic goods in the United States declined, and there was a relative overcapacity.

Faced with the severe economic situation, Reagan carried out a series of reforms, mainly including the following four aspects: First, implement tax reform, increase residents' income by reducing personal tax rates and encourage savings; encourage investment by reducing capital gains tax to stimulate economic development.

Second, cut social welfare and public spending, and expand the market supply of public products.

Third, relax industry regulations, including relaxing antitrust laws, abolishing oil price controls, and reducing intervention in the labor market.

Fourth, carry out financial system reform, including promoting interest rate marketization and allowing financial products to be freely priced.

 From the results, the US economy began to pick up in 1982, with GDP growing by 3.4% in the same year. From 1983 to 1988, the US GDP increased by 23%; the unemployment rate dropped from 9.6% in 1982 to 7% in 1986; inflation dropped from 13% in 1982 to 3% in 1986. However, Reagan's liberalization reforms also brought a series of problems. First, his tax reform did not achieve the expected goal of large-scale tax cuts, and the tax cut amount was only equivalent to 2.48% of the total annual tax revenue.

Second, during Reagan's term, the United States significantly increased its defense budget due to the Cold War between the United States and the Soviet Union. Instead of cutting government spending, it significantly increased the budget deficit and national debt.

Third, the financial liberalization caused by Reagan's financial reforms significantly increased financial risks and gave rise to the savings and loan crisis in the early 1990s.

　　**The second is the New Deal of Roosevelt, which began in 1932.**

From 1929 to 1933, a great crisis broke out in the capitalist world. The unemployment rate in the United States once reached 25%. A large number of companies went bankrupt and closed down, and farmers' lives suffered a heavy blow. Faced with this predicament, the Roosevelt administration implemented a series of economic policies centered on relief, reconstruction and reform, increasing government intervention in the economy to improve economic and social conditions. Specifically, Roosevelt's New Deal included the following: First, strengthen financial supervision and reform, stabilize and rebuild the financial system. The Roosevelt administration passed the Emergency Banking Act and made b[anking](http://quote.eastmoney.com/unify/r/90.BK0475) Act Amendments, created federal deposit [insurance](http://quote.eastmoney.com/unify/r/90.BK0474).

The Federal Depository and Clearing Corporation (FDIC) helped restore public confidence in [the banking industry](http://quote.eastmoney.com/unify/r/90.BK0475)[and](http://quote.eastmoney.com/unify/r/90.BK0473) The New Deal policy established a number of regulatory agencies, including the Securities and Exchange Commission (SEC) and the Federal Housing Administration (FHA), to ensure the transparency and stability of the financial market. Second, a series of public works programs and economic stimulus measures were implemented to stimulate economic growth and create jobs. Roosevelt's New Deal built a large number of infrastructure projects through the implementation of the WPA (Works Progress Administration) project and the CCC (Civilian Conservation Corps) program, and provided job opportunities for young unemployed people.

Roosevelt's New Deal also provided subsidies to farmers to encourage them to reduce production or plant other crops, adjusting the agricultural industry structure while protecting the interests of farmers. In addition, Roosevelt's New Deal protected the rights of workers by stipulating minimum wages, maximum working hours, and trade union organizations through national labor laws. A series of measures of Roosevelt's New Deal enabled the United States to quickly get out of the Great Depression and had a profound impact on the direction of action and policy framework of the subsequent US government.

Both Roosevelt's New Deal and Reagan's reforms were responses to the US economy when it encountered a crisis. Their policy goals not only focused on the emergency response of escaping the crisis, but also on how to promote long-term economic development.

Comparing the two, we can get the following inspirations: First, boosting consumption is a key link in expanding domestic demand and promoting economic recovery in the short term. Both Roosevelt's New Deal and Reagan's reforms took consumption as the starting point of their policies. The former used state power to increase consumption, while the latter stimulated consumption by increasing residents' income through tax reform.

Second, investment plays an indispensable role in overcoming economic downward pressure and achieving long-term economic prosperity. Roosevelt's New Deal's large-scale economic stimulus measures centered on infrastructure construction had an immediate effect on the US economy getting out of the depression.

Reagan's reform of increasing residents' consumption through tax cuts to boost the economy did not actually achieve the expected results. What really promoted economic development were tax incentives for high-tech companies and industrial investment brought about by the arms race. Third, a stable financial system is extremely important for macroeconomic development.

By strengthening the supervision of the financial system, Roosevelt's New Deal quickly restored the stability of the financial industry and citizens' confidence in the financial industry, promoting the recovery of the US economy. Reagan's financial liberalization reforms were originally intended to stimulate market vitality, but the lack of supervision also laid the hidden dangers for the savings and loan crisis in the early 1990s.

　　**Policy battle Against China**

On May 23, following her visit to China to discuss China's production capacity issues, Yellen once again raised the issue of "China's industrial overcapacity" and called on the Group of Seven (G7) to establish a "joint defense line" against China.

On May 14, Krugman publicly criticized China's development model, arguing that China is still focused on mass production rather than consumption, and the only way out is to maintain a huge trade surplus and dump products produced in China but that China cannot or is unwilling to consume into the markets of other countries. Regarding Yellen's "overcapacity theory" in China, the Chinese government has refuted it many times, so I will not repeat it here. I will only add that in April, when Yellen visited China for the second time in September, Yellen emphasized to the media that China is one of the important trading partners of the United States and that the United States has no intention of "decoupling" from China. Krugman, who won the Nobel Prize in Economics for his research on international trade, has clearly taken a firm stance to advocate protectionism and even advocated America First idea this time – in his article "Why not buy cheap Chinese [batteries ?](http://quote.eastmoney.com/unify/r/90.BK1033) Political Eceonomy”

Krugman wrote: **“In fact, in the 1990s, as China's exports to the United States surged, there was a famous debate about the impact of international trade on the United States. As for the outcome of the debate, "most economists - including myself (Krugman) - agree that imports are one of the reasons for the increase in inequality, but not the main reason".**

But with the rapid [growth](http://quote.eastmoney.com/unify/r/116.00001) and the continued sluggish employment situation in the United States, Krugman's views changed significantly after 2008: He wrote: **"At that time, I was quite tough on China, urging American policymakers to threaten tariffs unless China took action to reduce its trade surplus by appreciating the Chinese renminbi, but to no avail. However, this concern gradually disappeared. "**

**By the time of the**[**New York Times**](http://quote.eastmoney.com/unify/r/106.NYT)**article, Krugman's position was even clearer. Another point worth noting is that "Trump is an old-fashioned trade protectionist" and "But President Biden is by no means a free trade purist",** which are the first sentences of the first and second paragraphs of the Krugman article respectively. This shows that protectionism has become a consensus among all parties and among most of the economists in the United States to some extent.

　　The simplest and most powerful way to deal with such accusations, or policy debates, is to use facts. Here, we cite two sets of data from the China National Bureau of Statistics.

　　The first set of data is about the ratio of consumption and investment in China. The final consumption rate (i.e., consumption rate) refers to the proportion of final consumption expenditure to GDP, and the capital formation rate (i.e., investment rate) refers to the proportion of total capital formation to GDP.

**As can be seen from Figure 1, the changes in China's consumption rate and investment rate from 1978 to 2019 roughly went through three stages:**

the first stage was from 1978 to around 2000, when the final consumption rate was roughly stable at around 60%, and the investment rate was around 40%, and the proportion of final consumption expenditure in GDP was significantly higher than the proportion of capital formation.

**Translator: Consumption can be divided into two:** **final consumption and investment.** **Final consumption refers to the behaviour of people using the money they earn or receive to buy goods and services; investment refers to the behaviour of people using the money they earn or receive to buy assets (such as houses, stocks, government bonds, etc.) in the expectation of future gains or for the appreciation of their assets.**

 The second stage was from around 2000 to 2010, when the consumption rate showed a downward trend and the investment rate showed an upward trend; **the third stage was after 2010, when the consumption rate showed an upward trend and the investment rate showed a slowly downward trend.**



The second set of data is about the impact of investment, consumption and net exports on China's economic growth.

As can be seen from Figure 2 given below, the impact of the "three horses" on China's GDP growth from 1978 to 2019 can be roughly divided into four stages: the first stage was from 1978 to 1985, when the contribution rate of consumption to economic growth increased rapidly, the contribution rate of investment to economic growth fluctuated greatly, and the contribution of net exports to economic growth was negative.

 The second stage was from 1985 to 1995, when the contribution rates of the three to the growth of gross domestic product (GDP) fluctuated greatly.

The third stage was from 1995 to 2009, when the contribution rate of investment to economic growth fluctuated upward, the contribution of consumption to economic growth was relatively stable, and the contribution of net exports to economic growth during the same period was relatively small; **the fourth stage was from 2009 to 2019, when the contribution of investment to economic growth fluctuated downward, while the contribution of consumption to economic growth fluctuated upward.**



In 2020, despite the impact of the COVID-19 pandemic China’s final consumption expenditure still accounted for 54.3% of GDP, higher than the average level from 2011 to 2019 (52.1%), which was 11.2 percentage points higher than the investment rate of that year.

From 2021 to 2023, China’s consumption rate exceeded 60% on average, much higher than the investment rate of 30.9% in the same period, while the contribution rate of net exports to GDP in the same period was only 8.87%.

Consumption is the ballast stone for the stable operation of China's economy. In particular, in 2023, the contribution rates of final consumption expenditure and net exports of goods and services to China's economic growth were 82.5% and -11.4% respectively.

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From the above data, it can be seen that in recent years, the contribution rate of domestic demand to economic growth in country has continued to rise, and China’s economic growth is shifting from investment-driven to consumption-driven pattern.

At the same time, China continues to actively open up to the outside world and better assume the responsibilities of a major country.

The century-old epidemic and geopolitical conflicts have had a huge impact on the global economy, and China has continued to make the largest contribution of more than 30% to world economic growth with its own certainty. At the 2022 World Economic Forum, China issued the call of the times to "firmly believe and move forward courageously to create a better world in the post-epidemic era."

Also in 2022, the Central Committee of the Communist Party of China and the State Council issued the "Outline of the Strategic Planning for Expanding Domestic Demand (2022-2035)", and the National Development and Reform Commission formulated and issued the "14th Five-Year Plan for Expanding Domestic Demand Strategy Implementation Plan". At the just-concluded 15th Summer Davos Forum, the Chinese government once again emphasized its willingness to work together with all countries to advance hand in hand and set sail to face the growth difficulties of the world economy and create a "new frontier for future growth."

　　**Conclusion**

　　Consumption and investment are both important forces driving economic growth. The key is to formulate a reasonable policy mix based on a country's national conditions, especially the stage of economic development and the problems it faces.

　　For the current Chinese economy, consumption and investment are domestic demands, and the characteristics of the economies of major countries are that they are dominated by domestic demand and have internal circulation. In recent years, China has unswervingly implemented the strategy of expanding domestic demand, continuously enhanced the fundamental role of consumption in economic development and the key role of investment in optimizing the supply structure, and the economy has continued to recover and stabilize.

　　In the post-epidemic world, globalization is facing headwinds, the world economic growth recovery is weak, and the global trade growth rate is slowing down. China will further deepen reforms in an all-round way, accelerate the construction of a new open economic system with a higher level, provide global companies with broad market prospects, and jointly create new development space for the global economy.

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