



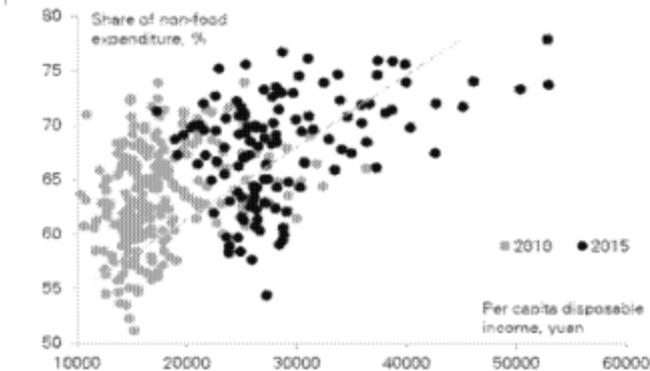
Evidence suggest that a consumption boom is an important driver for growth in 2017. Growth was strong despite subdued fixed asset investment and narrowing trade surplus. Consumer confidence index was at decade high and still rising. The boom is partly owing to wealth effect from property price increase in tier 2 and 3 cities.

Zhiwei Zhang, Ph.D.
 Chief Economist
 + [REDACTED]

In 2018 and beyond, consumption could surprise on the upside from two potential areas. First is consumption upgrade in tier 3 cities and rural areas. The fundamental driver for consumption is higher household income. As household survey suggests, income of tier 3 residents increased by 60%, and rural residents by 80%, in 5 years. Today's tier 3 city residents' per capita income is almost at the same level as that of the tier 2 cities just 5 years ago (Figure 55). The increasing shares of nonfood expenditure suggest that consumption upgrade is underway. Tier 3 cities and rural areas together account for 60% of retail sales (Figure 56). An acceleration in consumer spending by them could provide strong boost to aggregate demand.

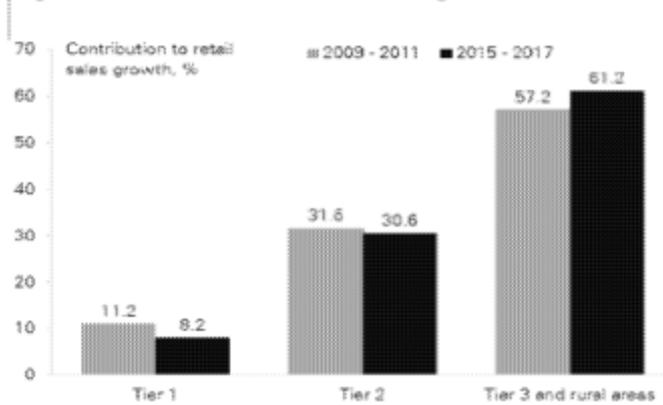
Yi Xiong, Ph.D.
 Economist
 + [REDACTED]

Figure 55: Disposable income and non-food expenditure, all cities



Source: Deutsche Bank, WIND

Figure 56: Contribution to retail sales growth



Source: Deutsche Bank, WIND

A second potential area is consumption spending in the services sector. Household spending on services, and particularly health and education, has been growing much faster than other components. There is a potential for services sector growth to surprise on the upside, as households may spend more on higher quality health and education services as their income increases. Uncertainty also arises from the difficulty to accurately measure the trends in the services sector, given the lack of high frequency statistics (services is not covered by retail sales or industrial production).