China Could Be Slowing Faster Than We Think

Whilst headline output numbers show China’s economy gliding – more or less – towards a soft landing, several indicators suggest the distinct possibility of a sharper-than-expected slowdown.

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Two types of landing

With the global economy in a fragile state, much is riding on Chinese growth. Policymakers and investors are grappling with whether China can avoid a hard landing.

The good news is that China’s recent macroeconomic data have been – broadly speaking – more positive than expected. This can be seen most clearly in the above-consensus GDP growth of 8.9% year-on-year (y/y) in the final quarter, showing only a mild slowdown from the 9.1% of the third quarter. Recent readings on industrial production growth, electricity consumption and the official purchasing managers’ index also support the case for optimism. Moreover, the fact that the People’s Bank of China (PBoC) did not cut reserve ratio requirements as widely expected in the run-up to the Chinese New Year holiday – waiting, in fact, until late February – suggests a certain level of ease with the current pace of growth deceleration. Taken at face value, all this suggests a moderation and stabilisation in China’s slowdown.

Li Keqiang economics

The bad news is that, given concerns about official data reliability, these headline indicators may tell only part of the story. Scepticism has been reinforced from the very top with the release of a WikiLeaks cable that detailed a 2007 conversation between then Liaoning Party Secretary Li Keqiang (now Vice-Premier) and then US Ambassador Clark Randt. The cable noted that: ‘when evaluating Liaoning’s economy, [Li] focuses on three figures: 1) electricity consumption…; 2) volume of rail cargo…; and 3) amount of loans disbursed…” The cable continued: ‘by looking at these three figures, Li said he can measure with relative accuracy the speed of economic growth.

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All other figures, especially GDP statistics, are “for reference only”, he said smiling... GDP figures are “man-made” and therefore unreliable’. Undoubtedly Li’s qualms lay primarily with provincial data, which is subject to greater potential for interference than national data, but nevertheless he confirmed widespread fears of manipulation.

Taking a cue from the Premier-in-Waiting, we take a leaf out of his book in getting a grip on economic output:

As noted above, electricity consumption appears to build the case for a moderation in the slowdown, given its uptick in December. Unfortunately, the November and December year-on-year numbers are compromised by the presence of idiosyncratic factors at the close of 2010. Rushing to meet energy efficiency targets laid down in the 11th Five-Year Plan, local governments actually forced factories across the country to shut down, thus rapidly reducing energy usage. Whilst the target was officially met, this meant that energy consumption was artificially low in the final quarter of 2010, and therefore, the year-on-year growth figures for the final quarter of 2011 should be artificially high. After crudely adjusting for this artificially low base, electricity consumption growth actually sinks well into single digits in the final month of 2011, as opposed to picking up from low double digits.

Growth in freight volumes at major ports sagged considerably in November (the latest available), down to 8% y/y from October’s 16%. Whilst this in part reflects a weak external climate as export markets slow, it certainly also reflects the slack in domestic activity, with firms scaling back imports amid lessening final demand.

Li’s third indicator – bank lending – is less telling today than it was back in 2007. Over the past five years, renminbi lending as a percentage of total credit issuance (as defined by the PBoC’s ‘total social financing’ data) has shrunk from around 80% to just over 50%. This dataset gives a more complete picture, but until recently was released only quarterly, so lacked granularity. The final quarter’s credit issuance did expand over the previous
period (at the peak of the credit squeeze), but remained very modest compared to the first half of the year and 2010. Although skewed by Chinese New Year, January’s credit issuance came in very weak, down almost half from the year before.

Taken together, Li’s numbers show an economy still very much in slowdown.

**GDP = Investment + Consumption + Net Exports**

Other indicators add weight to this pessimistic story. Indeed, if we look across the three broad drivers of GDP growth – investment, consumption and net exports – we see evidence of weakness throughout.

Start with investment, which has been the biggest driver of Chinese growth in recent years. Three micro indicators – growth in cement production, machine production and excavator sales – all line up with data showing a contraction in real-estate construction. Floor space under construction fell in December, with anecdotal evidence suggesting an extremely weak project pipeline and price data showing a sector still in the throes of correction. The data also highlight what is happening with China’s primary indicator for property investment – real-estate fixed-asset investment growth – which slumped dramatically in December. Outside of construction there are also worrying signs, with naphtha – a petrochemical feedstock and economic leading indicator – showing weak seasonally adjusted growth in the final quarter. Meanwhile, January railway investment fell to its lowest levels since 2009.

**Consumption** is harder to get to grips with in China. Retail sales are China’s primary indicator for household consumption, but are largely ignored on account of the poor quality of the dataset. The data are muddied by the inclusion of government spending and business-to-business sales, and also lack expenditure on services. As such, they fail to provide an accurate reading on levels of actual household spending. Even so, the Ministry of Commerce is reporting that China recorded its slowest New Year sales growth since 2009, and a full three percentage points below 2010’s level. Auto sales tend to be a
good alternative cyclical indicator of household demand, but according to data from the China Association of Auto Manufacturers, sales of Chinese vehicles contracted 26% y/y in January, with passenger vehicle sales falling 24% y/y.

The final part of the puzzle, net exports, will drag on – not contribute to – China’s growth this year, in large part due to the expected contraction in China’s largest export market – the Eurozone. Although slightly skewed by the Chinese New Year effect (with January this year having fewer working days than January last year), January’s trade data was the worst China has seen since the global financial crisis, with export and import growth plunging into negative territory. On account of the odd calendar effect (February this year will have more working days than February last year), export numbers will recover over the next couple of months, but 2012 growth will be around half that experienced in 2011.

Warning: Things could be uglier than we think

A look at China’s economy through the lens of various micro and proxy indicators is clearly a less-than-perfect approach. A decline in cement production growth, for example, tells you something about the cement industry, not necessarily the whole economy, and it is important to bear that in mind. Nonetheless, there is often little else to be done given concerns about the quality of Chinese data. Indeed, the greater the number of micro indicators telling a similar story, the harder the trends are to ignore. With cement, machine-tools and property construction all pointing down, the core of China’s investment growth is clearly soft at present; with a weak global outlook and a precarious Eurozone, net exports are likely to drag on growth; and with household spending driven primarily through structural factors related to income growth, it is unlikely that consumption will ride to the rescue.

Peering beyond China’s traditional output indicators highlights a worrying trend. We may still be waiting for that moderation in China’s slowdown.

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