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Economic Outlook

China: Bogus Boom?

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China's economic statistics have become the envy of the world. On July 15, China reported a 7.9 percent growth rate for the second quarter of 2009 compared to the same period a year earlier. Meanwhile, China's stock markets are on fire, and its property markets are heating up fast as well. Shanghai's two stock markets are up 75 percent and 95 percent respectively so far this year. The more widely traded Hong Kong Index is up 27 percent, a stellar performance compared to largely flat stock markets in the United States, Europe, and Japan. In even stronger contrast, Russia, which is one of China's emerging-market peers, has seen its economy drop by 10.1 percent during the first half of this year, while its stock market has struggled as well.

China's Growth Story

It is important to understand how China's remarkable reported economic performance is possible in the midst of a global recession. True, China enacted a massive stimulus package last November worth about 14 percent of GDP and aimed at boosting domestic demand as exports fell sharply. And exports are indeed still falling. As of June, China's exports were declining rapidly, at a year-over-year rate of 21.2 percent. Just two years ago, in 2007, its exports had grown 21.6 percent, but that was the last year of the global economic boom.

Make no mistake: China's 8 percent growth target for 2009 will be achieved, almost by definition. Whether or not that is a healthy outcome depends upon how you look at it and upon understanding just how China's economy functions and what China's growth "accomplishment" means. Chinese economic data are constructed very differently from the roughly comparable U.S. statistics, so that looking at Chinese data through a lens conditioned by U.S. data-building and reporting conventions can be misleading.

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China has a planned economy; policymakers have substantial control over the path the economy takes and certainly over the path of reported data. Consider, for example, events that transpired in the global economy at the end of last year and their impact on China's economic policymakers. After the financial panic following the demise of Lehman Brothers, real economic activity, and particularly activity in the global traded-goods sector, virtually collapsed during the fourth quarter of 2008 and the first quarter of 2009. Chinese planners reached a decision in November 2008 to provide a massive stimulus program (equal to about 14 percent of GDP or about RMB 4 trillion) to bolster Chinese growth. In fact, they were reversing what had been measures aimed at slowing growth by restricting money and credit flows. The quick transition from tight to easy credit conditions was accompanied by measures directed at boosting domestic demand and infrastructure spending in particular. While the entire stimulus package probably was not an addition to existing plans, and probably will not be fully implemented during 2009, it is sufficiently large to generate 8 percent growth during the year—at least in the way China measures growth.

China's 8 percent output growth target will be met because China's economic statistics are based on recorded production activity, rather than being

a measure of expenditure growth—defined as the sum of consumption, investment, government spending, and net exports—as U.S. data are. The U.S. stimulus package, for example, attempts to boost GDP by undertaking measures that will boost consumption, investment, and government spending. China, however, decrees measures that will generate recorded increases in production spending. Part of the Chinese stimulus package involves large transfers of funds from the central-government planners directly to state-owned enterprises and to fixed-asset investment projects that are aimed at public works spending largely under its control.

Once China had announced its 8 percent growth target, it began to disburse funds directed at a sharp increase in public works spending. It is important to understand that the disbursal of funds is recorded as GDP growth. So the government can easily control the pace of growth by the pace at which it releases funds that have already been allocated in the stimulus package to the creation of higher production or growth numbers. Funds disbursed for fixed-asset investment by state-owned enterprises or provincial governments are counted as having been spent when they are disbursed. In fact, the funds go out to the state-owned enterprises and provincial governments and may be held until actual projects are identified and undertaken.

The same convention, counting production and shipments as de facto outlays by end-users, is employed with respect to retail sales data in China. Shipments to retailers are counted as retail sales on the apparent assumption that ultimately all goods shipped will be sold at some point in the future. China's nominal retail sales have been rising at a rate of about 15 percent year-over-year during the first half of 2009 because that is the rate at which shipments to retailers have been occurring. There is very little direct data available to measure actual sales by recipients of the retail shipments to ultimate consumers.

The problem with China's approach to the economic data, counting shipments as sales and funding of projects as projects undertaken, is that there may be substantial lags in the real impact of government programs as well as substantial lags in actual spending on goods shipped to retailers. China's policymakers can monitor the potential gap between demand growth and the production numbers recorded as GDP growth by watching the progress of infrastructure projects being funded and by monitoring inventories of unsold goods. Unfortunately, outside observers cannot monitor such progress since the information on inventories and the progress of actual outlays on infrastructure projects is not publicly available.

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It is possible, however, to make inferences about the pace of demand growth relative to production or supply growth in the Chinese economy by watching the behavior of the central bank and its control over the growth of money and credit. If policymakers observe that demand growth and progress on infrastructure projects is lagging behind announced production-side GDP data, they can attempt to boost demand growth by increasing the growth of money and credit. Such growth has accelerated sharply during the second quarter in China, indicating that while the measured pace of China's increase in production is rising, the public works projects and actual spending already recorded are falling behind schedule.

Money and Credit Spike Upward

Chinese measures aimed at boosting demand growth to meet ambitious production growth targets intensified sharply at the end of the second quarter. In June, growth in the money supply measure known as M2 surged to 28.5 percent year-over-year—up sharply from a 15 percent rate at the beginning of the year, which was far more typical of the pace of money growth over the past decade. New loans by banks rose by about $1 trillion, or twice the expected rate, during the first half of 2009 and rose 34.5 percent year-over-year in June from a 30.6 percent growth rate in May. It appears that Chinese policymakers are experiencing difficulties in prompting total spending to match their ambitious growth targets implied by a production growth target of at least 8 percent, and so they have allowed a rapid surge of money and credit at midyear. The resulting flood of money has—somewhat counterproductively—flowed into stocks, property markets, commodity stockpiles, and consumer durables (with the help of special incentives for purchases of durables). There are anecdotal reports of Chinese households buying washing machines that were aggressively shipped and counted as retail sales during the first half of the year. However, many of the households that purchased washing

machines, or were virtually given such machines, have found them unusable because their homes lack either the running water or electricity (or both) necessary to make use of a modern appliance. Such problems arise when ambitious planners count shipments as retail sales while end-use demand may be absent. In such cases, the "sales" are made to happen by virtually giving away the products that have already been produced and counted as GDP growth.

On a broader scale, part of the enhanced money-credit stimulus being undertaken in China reflects concerns there that global trade growth—especially that tied to U.S. demand—will not resume in the second half of 2009. In order to underpin domestic demand growth, China's central planners are willing to let the flood of cash boost stock and property prices in the hope that this will raise confidence sufficiently to increase spending inside China. This is a risky undertaking, as reflected in the virtual doubling of the Shanghai Stock Market so far this year and the reappearance of real estate speculation during the second quarter. Speculative flows into Chinese stock and property markets have become so intense that authorities fear any abrupt cessation could burst the equity bubble, especially given that the state-owned enterprises and other recipients of stimulus funds have purchased stocks themselves rather than leaving funds idle until they can be disbursed for actual projects and have already been counted in GDP data as having been undertaken. China's State Council apparently has decided to overrule those at China's central bank—the People's Bank of China—who are worried about the bubbles and to keep the party going with continued rapid money and credit growth.

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It is the intensification of efforts to use rapid money expansion that serves as evidence that private consumption and private investment have remained weak even though they are difficult to measure since little data are available on such demand-side components of GDP. Meanwhile, as already noted, China's export growth remains weak, with exports dropping at a year-over-year rate around 20 percent during the first half of 2009, after growth rates of 17 percent in 2008 and 25 percent in 2007. Having announced a stimulus package that will boost domestic demand in order to compensate for the loss of export growth on overall economic growth, China's planners are not about to risk any cessation of the intense monetary stimulus currently underway. That said, there are signs that problems are emerging from China's growth policies that amount to assuming that supply creates its own demand with the help of adequate monetary stimulus.

Goods Inflation Still Absent . . .

China's year-over-year consumer price index inflation rate is still negative, mostly because of far higher energy prices last year. But the threat of higher future inflation is emerging and has raised public concerns at the People's Bank of China. The surge of Chinese flows into the stock and property markets has been intensified by rising foreign capital inflows to China. Foreign investors are starting to pile on to China's liquidity-driven flows into those markets. An estimated $25 billion of "hot money" (inflows less trade surplus and foreign direct investment) surged into China in June. This may not end well—bubbles burst even in China—but it probably has a way to run, taking Chinese stocks, property, and commodity prices with it. There has been, and will continue to be, some positive spillover into prices in global commodity and stock markets as we saw in mid-July.

. . . But Asset Prices Accelerating

The big risk from higher inflation in China lies with the problems faced by typical Chinese households with wealth storage. Chinese households save a high portion of their income because they have to provide, on their own, for health care, retirement, emergency outlays, and other needs that are provided by governments in most advanced economies. Typical households have limited alternatives beyond stock-market and property speculation as ways to preserve wealth in an environment of rising prices. As we move into the second half of the year, year-over-year inflation will almost certainly pick up in China simply because last year's rapid run-up in energy prices happened during the early part of the year and abated later in the year. So year-over-year comparisons will shift from a reference point with very high prices to one with more moderate ones. Already, the house price index in thirteen major cities has risen about 13 percent from its February low, suggesting that easy financing and concerns about rising prices are pushing Chinese households and investors rapidly into the property market. China's decision to allow this to happen as a way to boost overall demand and confidence is a risky one because it looks as

though a bubble may be developing in China's property markets alongside the bubble that has already emerged in the stock market.

Another tricky problem involves the potential upward pressure on sensitive food prices in an environment of rapidly rising inflation in China. One-third of the consumer price index basket involves food, and pork is a major component of food prices. Pork prices are a highly sensitive issue for most households in China, with price shocks in pork likely to generate widespread dissatisfaction among China's households.

Risks Ahead for China

China's aggressive attempts to maintain an 8 percent growth rate for an economy that is export-oriented in a world in which global trade volumes are collapsing carry substantial risks. It is already clear that China's ambitious production goals are outstripping the capacity of the domestic economy to absorb fully the output generated under those growth goals. Clearly, China's State Council, by overruling the central bank's wish to rein in rapid money growth, is prepared to risk higher inflation in order to keep China's economy on the 8 percent growth path laid out at the start of the year.

The consensus forecast, including that of the U.S. Federal Reserve, that U.S. growth will pick up in the second half of the year, along with optimism about growth in other industrial countries, has probably convinced the State Council to keep pushing along the growth path in the hopes that a resumption of export growth, or at least a moderation in its slowdown, will make it possible to achieve the 8 percent growth target without risking an inflation rate that is too high. That said, there is little evidence in the U.S. data that second-half demand growth will be sufficient to produce a positive growth rate for the economy as a whole. Rather, it looks like second-half U.S. growth may average around –2 percent, as opposed to the consensus figure that is closer to 1 percent. Meanwhile, there are no signs of a rapid pickup in European growth, and Japan's growth forecasts are being scaled down for the second half of the year as capital expenditure weakens sharply and exports continue to languish.

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The worst outcome for China would be one that includes ever-rising inflation pressures, as money and credit flows augmented by "hot money" capital inflows push the inflation rate up to a level that threatens China's stability. Since that would be most likely under a scenario in which industrial economies are not recovering in the second half of the year, we could see a situation in which disappointment over the recovery in the big three economies coincides with disappointment about the sustainability of China's planned 8 percent growth path. That outcome would coincide with a likely bursting of the stock and property market bubbles that are inflating in China now on the hopes that a second-half recovery will validate China's goal of sustained 8 percent growth in 2009.