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Can China Keep Growing?

By John H. Makin

"The Chinese economy has shown signs of recovery on the whole, but we are still in a tough fight with the global financial crisis."

—Zhou Xiaochuan, governor of the People's Bank of China, April 18, 2009

Governor Zhou Xiaochuan's comment is an open acknowledgement that the "adverse feedback loop," in which financial-sector problems hurt the real economy, which in turn intensifies negative conditions in finance, has hit China hard. China's real growth rate, which peaked at 13 percent in 2007 and is heavily dependent on exports, plunged to 6.1 percent on a year-over-year basis in the first quarter of 2009. Nominal growth, a measure of the current money value of goods and services, fell even more sharply, from 21.4 percent in 2007 to 3.6 percent in the first quarter of this year. The fact that the nominal growth rate is 2.5 percent below the real growth rate suggests that, at least as far as output is concerned, deflation has taken hold at a 2.5 percent rate in China.

The plunge in real and nominal Chinese growth has been extraordinarily sharp and has been more severe than one might have anticipated on the basis of past performance. Even in 1998, after the Asian crisis had produced sharp slowdowns across the region, China's nominal and real year-over-year growth rates were 7.8 and 6.9 percent, respectively. Today, even though the headline real growth number is 6.1 percent, what is important is that the figure is now well below what had been assumed as recently as early this year to be a growth floor of about 8 percent. The still-weaker nominal growth rate of 3.6 percent is as rare as a negative year-over-year nominal growth rate for the United States and reflects heavy downward pressure on corporate profits and sharply weaker exports, which drained an estimated 4.5 percentage points from Chinese growth during the first quarter of this year. The annualized drop in China's nominal GDP rate for the first quarter of this year was an astonishing –15.3 percent, underscoring how misleading the headline year-over-year real growth number of 6.1 percent may be.

The data on China's economy, critical as that information is for the global and especially the Asian economic outlook, should, it must be noted here, be viewed with some caution, especially at turning points. Some observers are skeptical about the accuracy of data reported during the last Asian crisis, suggesting that 1998 growth data, in particular, were too sanguine. More broadly, since China reports only nominal GDP data on a year-over-year basis and excludes important details like separate inventory data, the difficulties in arriving at accurate real growth numbers, especially quarterly numbers, are formidable. The bottom line: a little extra skepticism is in order when viewing Chinese data in the midst of a global economic crisis. That said, we continue with discussion of China's published data.

Why Has Chinese Growth Plummeted?

Just as U.S. consumption and GDP growth were victims of the adverse feedback loop that followed

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from the rising financial stresses for the U.S. economy during 2008, so China's growth fell victim to the collapse in U.S. and global spending after mid-2008. A key part of the rapid run-up in American and global growth into 2007 was a reflection of an underlying reality: America consumes, and China produces. As American wealth grew rapidly on the strength of massive wealth gains from rising stocks and rising home values, American consumption surged. Americans stopped saving, and instead an innovative financial system enabled them to liquefy (for consumption) the increases and expected increases in the value of their securities and homes.

The Chinese invested heavily and produced more goods, which were shipped to America and other G7 countries for consumption. When the surge of Chinese exports generated a balance-of-payments surplus, rather than allow the surplus to push up the value of its currency, China elected to hold its currency below market-equilibrium levels, thereby making Chinese goods artificially cheap and encouraging their sales worldwide. The dollars that the Chinese purchased to keep their currency from appreciating were recycled back into U.S. credit markets, especially the market for Treasury securities, thereby helping to keep U.S. interest rates low and further boosting the growth of U.S. spending.

The sharp contraction of U.S. consumption at a 3.8 percent rate in the third quarter of 2008 and a 4.3 percent rate in the fourth quarter of 2008, together with the stagnation of credit markets and comparable spending slowdowns in most G7 countries, depressed China's exports. Year-over-year growth of Chinese exports went from an average of about 22 percent during the first three quarters of 2008 to 4.4 percent in the fourth quarter of 2008 and down sharply to –19.7 percent during the first quarter of 2009.

The Chinese Response

If America stops consuming, what will China do? The Chinese quickly realized that the hesitant and slow policy responses to the collapse of demand growth that appeared in much of the world during the second half of 2008 made matters worse. Chinese officials moved aggressively in November 2008 to introduce fiscal stimulus measures worth about 2 percent of GDP for 2009 and 2010, according to International Monetary Fund (IMF) estimates. China's headline stimulus figure, RMB 4 trillion, or about $586 billion, is an extraordinary 12 percent of the nation's GDP. Some double counting and the fact that the stimulus measures are spread over a number of years account for the IMF's lower estimate of this fiscal stimulus at about 2 percent per year.

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The Chinese have substantial advantages over western democracies when it comes to effecting rapid stimulus. The November measures—in their early stages at least—were apparently directed toward infrastructure projects and state-owned enterprises, so that even with overall growth rapidly weakening during the first quarter, fixed-asset investment (which includes investment in infrastructure projects, capital equipment, and inventories) rose at a 28.6 percent year-over-year rate—up from 23 percent in the fourth quarter of 2008. In contrast, U.S. investment growth is collapsing this year.

While U.S. businesses and households have found it difficult to obtain credit during the intense financial crisis, Chinese businesses and households have been deluged with credit during the first quarter of 2009. Party operatives directed banks to increase lending, and the result was a massive surge in credit flows, largely to nonfinancial businesses. During the first quarter of 2009, a total of RMB 4.6 trillion—almost equal to the RMB 4.9 trillion in loans made during all of 2008—had been extended. Year-over-year loan growth jumped 30 percent during the first quarter of 2009. New loans reached 17 percent of GDP during that period, which would be almost $2.5 trillion in U.S. terms. Chinese businesses and some households, at least those designated worthy by the Chinese economic policy planners, are suffering from no shortage of credit. On the contrary, they are being showered with it. This has set a new standard for what constitutes an aggressive policy response in the face of the global financial economic crisis.

The Chinese clearly understood how an adverse feedback loop from deteriorating financial conditions to the real economy and back can devastate an economy, and they drowned any possible deterioration of available credit with an unprecedented expansion of loans during the first

quarter of 2009. If we recall that this expansion of credit has come on top of a timely and rapidly applied fiscal stimulus package and yet that the nominal first-quarter growth rate was nevertheless weak (only 3.6 percent with implied deflation), we can begin to appreciate the force of the negative shock that hit the Chinese economy after G7 demand growth collapsed in the second half of 2008.

Will China's Stimulus Plan Work?

There is a real parallel between the responses of American and Chinese policymakers to the collapse in financial and economic conditions confronting them. Both responses are—somewhat ominously—aimed at replicating forces that created the boom/bubble in the first place. One of the major causes of the collapse of the American house price bubble was the existence of too much easy credit to purchase homes. Of course, the response of the U.S. Congress and the executive branch is to shore up the major agents of easy credit for the housing sector, Fannie Mae and Freddie Mac, so that they can continue to offer easy credit for prospective homebuyers. That said, given that the latest Case-Shiller Home Price Index indicates that American home prices are dropping at about a 25 percent annual rate, there is little danger that such lending subsidies to homebuyers or prospective homebuyers will do much more than slow the drop. Beyond that, many of the U.S. mortgage-lending subsidy programs have produced only limited additions to available credit.

In China, the growth boom was driven by exports, which were, in turn, produced with a high level of national investment—equal to about 50 percent of GDP. The response to a collapse in the demand for those exports has been to provide massive credit subsidies to continue the capital investment that increases the capacity to produce and sell more exports. This tilt toward investment is indicated clearly by the fact that the bulk of the massive first-quarter credit growth of RMB 4.6 trillion (about 17 percent of Chinese GDP) went to businesses, with the result (as noted above) that Chinese investment actually accelerated during the first quarter of 2009 while exports collapsed and retail sales slowed. Beyond that, a substantial portion of the Chinese liquidity surge appears to have spilled over into equity markets. So far this year, the Shanghai market is up nearly 40 percent even as the economy is slowing. Either Chinese investors are betting on a sharp rebound in profitability, not particularly likely in view of the collapse in nominal GDP growth, or they are simply recycling easy credit into the purchase of equities, thereby raising the possibility that China's ever-volatile equity market may become even more volatile.

The Chinese have sharply increased government spending and credit flows to investment in state-owned enterprises, public works, and other means to increase productive capacity. At a time when global demand is collapsing and Chinese exports are collapsing along with it, these measures amount to a risky doubling down on the strategy that has worked in the past. Adding productive capacity in China at a time when global demand has swooned is a recipe for more deflation pressure. Specifically, as Chinese exports fall sharply and capital inflows to China fall off rapidly, the underlying Chinese balance-of-payments surplus is being reduced and may even disappear. As a result, China may find itself facing a balance-of-payments deficit and needing actually to sell dollars to support the yuan against the dollar and other major currencies. The alternative, which may become increasingly attractive if the global crisis continues, would be to let the yuan depreciate and thereby help to increase the sale of Chinese exports in global markets by lowering their prices in terms of foreign currency. Of course, this step would amount to a wrenching transition whereby China, once the engine of global growth, would be transformed into an exporter of deflation into what is already a deflationary global economy. The pressure on other Asian exporters like South Korea, Taiwan, Indonesia, and Singapore would be devastating, coming on top of the problems already visited upon those economies by the collapse in global trade. Global trade tensions would surely rise as a result.

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What Helps?

How are stock market investors and Chinese policymakers alike? Both are counting heavily—very heavily—on a stabilization and recovery of U.S. growth during the second half of 2009. The consensus forecast for U.S. growth for this year, with which the Federal Reserve Board concurs, is

for modestly positive growth during the second half following a dismal growth rate of somewhere around –6 percent in the first quarter and then –2 percent in the second quarter.

The key aspect of the call for a stabilization of U.S. growth in coming quarters is the expectation that the nearly unprecedented run of negative consumption quarters will end. Negative consumption growth subtracted about three percentage points from growth during the second half of 2008. Before then, only three episodes of two consecutive quarters of negative consumption growth in the United States had been recorded since the end of World War II, with the latest one during the first half of 1991. That episode subtracted a far more modest 1.5 percentage points from growth.

With considerable help from extra-large tax refunds, running 15 percent above year-ago levels; a cost of living adjustment for Social Security recipients beginning in January; and the reduction in April of payroll tax withholding rates as part of the U.S. stimulus package, the consensus forecast is for consumption growth to stabilize during the first half of the year. The stabilization of consumption growth is expected to be sustained partly because in most past cycles the recession has begun with a sharp slowdown in consumption growth that has moderated about midcycle. However, that outcome is related to the fact that most postwar recessions are caused by Fed tightening in the face of feared inflation. This time, the economy collapsed while the Fed was easing too slowly, as Chairman Ben Bernanke has acknowledged.

In a typical downturn, where Fed tightening contracts available credit, household spending falls as a result. Once the initial tightening is past, spending growth resumes. Even in the unusual circumstances where consumption growth actually turns negative in a recession, there has never been a case where the run of negative consumption growth numbers exceeded the interval of two quarters that we witnessed last year. With consumption growth modest but positive, where consumption accounts for nearly 70 percent of GDP, a very sharp drag from net exports and investment is required to produce negative growth numbers overall. While this probably occurred during the first quarter, optimists are betting that a lower drag from investments and net exports together with stable consumption will push U.S. growth into positive territory by midyear.

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It is important to recognize, however, that we are in an unusual business cycle, one that includes sharp income losses tied to very large cumulative job losses, with employment dropping at a 3.5 percent year-over-year rate. Wealth losses through the end of the fourth quarter totaled about $15 trillion, which, using a rule of thumb that about 6 percent of wealth losses are subtracted from consumption, would reduce consumption spending by about $900 billion—or about 10 percent of annual real consumption. Wealth losses, the crisis of confidence tied to a rapidly rising rate of unemployment, and problems tied to the unavailability of credit already have caused spending growth to lag far behind the growth of real disposable income. Over the six months ending in February, real consumer spending fell at a 1.9 percent annual rate while real disposable income, helped in part by accelerated tax refunds during the first quarter of 2009, rose at a 4.6 percent annual rate. For consumption growth to stabilize and remain positive during the second half of 2009 will require both sustained increases in personal income and a reversal in the increase in the saving rate implied by spending growth that is slower than income growth. This may not occur unless financial-sector stresses (to begin with, house prices falling at a 25 percent annual rate) ease and unemployment stops rising rapidly. It is by no means clear that these supportive events will occur by midyear.

By June, much of the extra support from accelerated tax refunds and other measures, besides the modest support from the tax rebates under the stimulus package, will be reduced. Simultaneously, with no indication that the sharp increase in the rate of unemployment and the associated fall in wages will be mitigated, spending growth is likely to remain weak.

The other aspects of a pickup in GDP growth for the second half of the year include a moderation in the collapse of fixed investment that is underway in the first quarter and substantial moderation in the fall of residential investment. While the drag on GDP growth from collapsing residential fixed investment is likely to fade away simply because housing starts cannot fall much further, the drop in business fixed investment may persist. Beyond that, net exports may continue to drag down U.S. growth in view of the sharp slowdown in global growth. Help from the government sector will increase somewhat, but many of the stimulus package measures are directed at federal

support for shrinking state and local government programs, so that the overall effect on GDP growth of government spending will be modest.

China's response to its slowdown—boosting investment—exacerbates the excess capacity problem that is already depressing investment worldwide. Any U.S. company, for example, contemplating an investment where output will have to compete with similar products supplied by Chinese producers may be discouraged by the likely need to contend with extra negative pricing pressure and, in the more extreme case, with a weakening Chinese currency.

Erratic Progress

Rather than a smooth transition from negative to positive growth rates as 2009 unfolds, U.S. growth may be more likely to pick up slightly at midyear—perhaps to a 1 percent annual rate—and then slip back to a negative rate by late in the third quarter or during the fourth quarter, as continued increases in unemployment, income losses, unavailability of credit, and wealth losses depress consumption growth. Household income growth, even with the modest support provided by payroll tax rebates in the stimulus package, may simply be inadequate to support consumption growth. This scenario is not generally expected to materialize, but the fact that it is plausible and, further, the fact that stock markets and the Chinese have already bet on a sustainable recovery mean the stock markets and China's investment-stimulus strategy face significant downside risks.

U.S. stocks have risen by about 25 percent from their early March lows largely on the basis of a 70 percent increase in financial-sector share prices. The sharp recovery in financials, admittedly from extraordinarily low levels, is tied to an expected resolution of the balance sheet problems plaguing the financial sector. Suffice it to say that, so far, while bank income statements have improved modestly, banks have contented themselves with simply ignoring the substantial balance sheet problems that continue to impede normal lending to households and businesses. As long as house prices keep falling, bank balance sheets remain compromised, and unemployment keeps rising, the bet on a second-half recovery is a questionable one.

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China wants to grow at an 8 percent rate during 2009. In order to achieve that goal, the government has implemented, with great speed, a stimulus package worth about 2 percent of GDP for both 2009 and 2010 and augmented it with massive credit growth injected at a rate of about 17 percent of GDP during the first quarter of the year. There is a problem, however. The credit growth is being directed to investment—capacity expansion—at a time when global demand growth is collapsing. The Chinese could, perhaps, do themselves and the global economy a favor by directing some of the credit growth to consumers to boost retail sales and demand growth as rapidly as possible.

With all that said, unless sustained positive U.S. consumption growth appears at midyear, it will be extraordinarily difficult for China, along with the other export-oriented economies in Asia, to sustain high growth rates based on rebounding exports—at least not without sharp, destabilizing currency weakness. Perhaps more likely is an outcome whereby excess capacity increases and thereby exacerbates global deflation pressures emanating from the traded-goods sector. G7 central banks, with some firepower left in Europe and perhaps in the United States, will have to keep expanding aggressively until the balance sheets of the commercial banks are cleaned up and they get back into the business of lending. It is also important to preempt an increase in export subsidies from Asian exporters that could escalate global trade tensions and the threat of a trade war—the last thing we need in this current, continually challenging environment. To paraphrase and broaden the comment of Governor Zhou, "we are all still in a tough fight with the global financial crisis."