Assessing the slowdown in China

Key Points

- Growth in China has slowed dramatically over the past year from a blistering pace of over 13% in 2007 to just 6.1% in 2009 Q1. A turning in the domestic investment cycle has been coupled with a dramatic slowdown in external demand leading to a build-up of excess capacity, particularly in heavy industry.
- Exports have fallen sharply and China is a much more open economy, with a higher level of value-added and domestic production content in its exports than in previous decades. So external shocks are likely to have more of an impact now and we expect the boost from net trade to disappear over the next couple of years.
- Economic cycles in China are predominantly driven by retrenchments in private investment so near-term prospects will depend in particular on private investment. The government has been successful in increasing the supply of credit, as shown by this year's surge in lending, but a key question is whether this will be translated into profitable investments by private companies.
- Retail sales have been robust though the consumption of durables has been more affected by the slowing housing market. But the outlook for consumption will depend on how well employment and wage income holds up. Over the medium term, consumption is likely to increase as a share of GDP as urbanisation continues and government spending on health and education increases.
- While only a proportion of the large CNY4 trillion fiscal package represents new spending, it will provide a significant boost to growth both this year and next. The impact will come through a boost to government investment as well as an increase in government consumption and transfers.
- Despite the unprecedented fiscal package, however, in the near term we expect growth to dip below 6% with private investment hit by weak demand. But growth should begin to recover strongly towards the end of this year as the fiscal stimulus comes on stream, rising to 10% by end 2010.
- Some green shoots of recovery are already emerging with a pick-up in manufacturing new orders and strong growth in credit. Nevertheless, more fundamental downside risks remain if rising unemployment leads to social instability or if an increase in loss-making investments uncovers weakness in the banking sector.

Introduction

Growth in China has slowed dramatically over the past year from a blistering pace of over 13% in 2007 to just 6.1% in 2009 Q1. A turning in the domestic investment cycle has been coupled with a dramatic slowdown in external demand. Despite an unprecedented fiscal package, in the near term we expect growth to dip below 6% but it should begin to recover strongly towards the end of this year as the fiscal stimulus comes on stream, rising to 10% by end-2010. Indeed, some green shoots of recovery are already emerging with a pick-up in manufacturing new orders and strong growth in credit. Domestic demand may be recovering but the impact of the external crisis on China’s growth prospects is uncertain. Nevertheless, more fundamental downside risks remain if rising unemployment leads to social instability or if an increase in loss-making investments uncovers weakness in the banking sector. By looking at what has driven the recent slowdown and how this compares with previous downturns, we can shed light on China’s prospects going forward and the major risks.

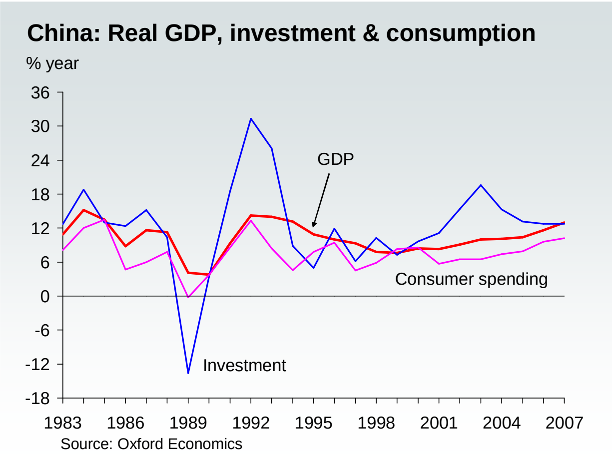
What has driven this slowdown and how does it compare with previous downturns?

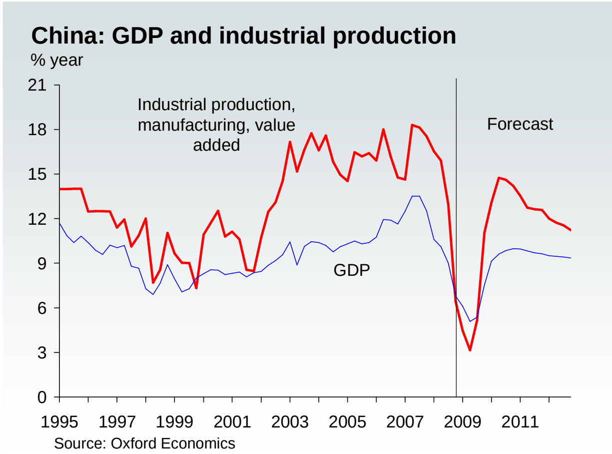
GDP growth started to slow rapidly in the second half of 2008 to reach 6.1% in 2009 Q1, with the slump highlighted even more by an upward revision to growth in 2007 from 11.9% to 13.0%. The latter revision goes some way to resolve a recent puzzle. Growth in industrial value added in recent years has been much stronger than overall GDP growth and as this accounted for nearly half of output many had suspected that the strength of GDP growth was under-reported. But no-one questions that China is now experiencing a sharp slowing in growth and the annual figure of 6.1% disguises the speed of the slowdown. Using a seasonal filter, the Chinese economy hardly grew at all in the fourth quarter of last year, with quarter-on-quarter growth the weakest since the contraction in the early 1990s. While quarterly growth picked-up in 2009 Q1, it remained well below its long-run average.

On the basis of the rapid deceleration in exports seen in recent quarters and sharp drops in other indicators such as electricity output, which fell by 6% year-on-year in Q4 compared with growth of close to 16% at the beginning of last year, some commentators have argued that growth has slowed even more sharply than the official figures would suggest. But the link between electricity output and GDP has weakened in recent years and some temporary factors related to the supply of energy also explain the sharp drop.

Similar to the pattern during the upswing, in terms of domestic output the slowdown has been driven by a sharp moderation in industrial output. Growth in the gross value added of industrial production began to slow sharply in October last year, falling to a low of 5.4% in November, well below the average of 16% in recent years. Within this, the slowing was most dramatic in heavy industry. The pattern has continued this year with industrial output only growing by 3.8% in January-February compared with the same period last year. But industrial output rebounded in March with a growth of 8.3%. The PMI confirms the recovery in manufacturing output with a rise to 56.9. New orders according to the PMI were also strong at 54.6 but these have been driven by improving domestic demand with export orders remaining weak at 47.5.

Much of the slowdown in output relates to a build-up of excess capacity driven by a turning in the domestic investment cycle, coupled with a severe slowdown in external demand. While growth in tertiary industry (mostly services) in recent years has followed a similar cycle to manufacturing, growth in agricultural output actually increased during 2008. But China has become a much less agrarian society and the share of agriculture in output has fallen from around 25% at the beginning of the 1990s to 10% now.





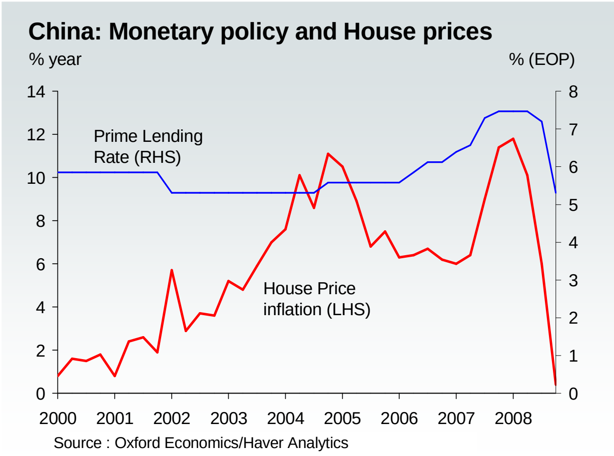
What has driven the slowdown in terms of expenditure?

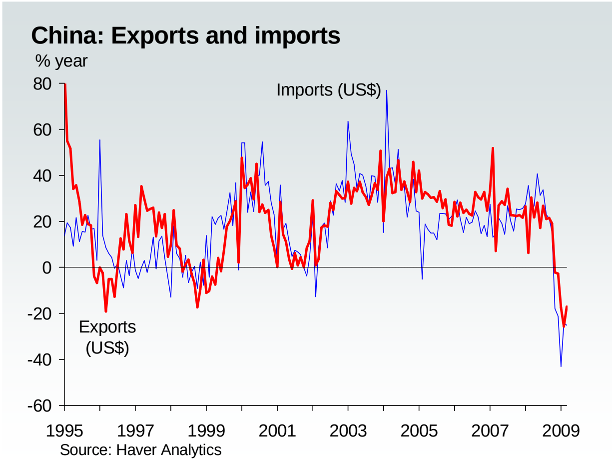
On the domestic front, China has been facing a bursting of a property bubble (particularly in commercial property and luxury flats in urban areas), as well as a turning in the domestic investment cycle. It is easy to forget how different the story was for China little more than a year or so ago, when the government was under pressure to slow an economy that was quickly overheating. Inflation rose rapidly during 2007, nearing a peak of close to 9%. While temporary effects such as the sharp increase in oil and commodity prices and rises in food such as pork played a part, with output growth above potential for much of the previous four years, domestic inflationary pressure was the underlying cause. In response, the People's Bank of China raised interest rates by over 100bp in 2007. The combination of the rising cost of credit and more restrictions on its availability will have increasingly weighed on investment.

The chart above shows that economic cycles in China are predominantly driven by retrenchments in investment. The slowdown in growth in 1989 was driven by a sharp drop in investment growth as the government restructured many of the state-owned enterprises (SOEs). GDP growth slowed to 4% in 1989 and 1990 in China's most serious downturn since reforms began in 1979. Academic studies have shown that it is mainly the turning in investment by private enterprises that is responsible for most economic cycles in China[1]. During the Asian crisis, growth only slowed modestly to below 8% as a surge in government investment offset weaker private investment and net trade. Above-trend growth since 2003 has been characterised by strong private sector and government investment.

Could a sharp slowing in private sector investment be responsible now? The dramatic fall in imports in recent months suggests it could. While some of the slowing in imports will be related to a drop in demand for inputs into manufacturing exports and the lower cost of commodities, import growth has fallen quicker and further than export growth, suggesting a slowing in domestic demand as well. With retail sales growth robust, investment may be the underlying cause. One puzzle is that the monthly figures for fixed investment have not shown any abatement over the course of last year, with nominal growth for 2008 at 26% – and growth picked up further in 2009 Q1 to close to 29%. Indeed, as a whole, available expenditure data do not suggest a particularly sharp slowing in overall GDP growth. So it may be that a running down of inventories has also contributed to the weakness in growth. This suggests that some of the weakness could be temporary if final demand remains fairly robust, as firms would then need to rebuild stocks.

[1] *See Reidel, J., Jin, J. and Gao, J. (2007), 'How China Grows: Investment, Finance and Reform', Princeton University Press.*



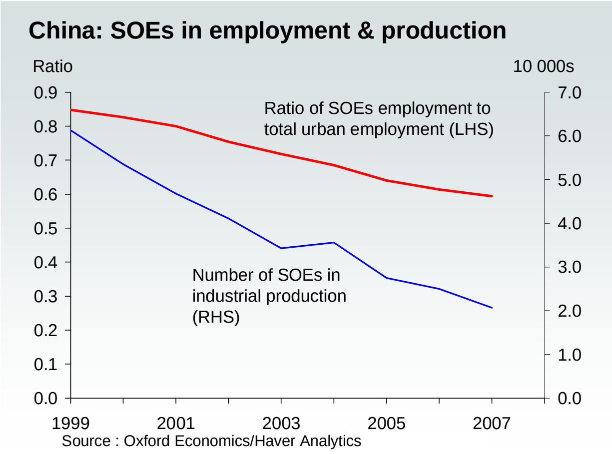


How will the drop in external demand affect China's prospects?

With China's major trading partners now in recession, external demand has fallen away at the same time as domestic demand has been hit. Exports fell by 21% in Jan-Feb over the same period last year with some improvement evident in March with a smaller drop of 17%. Nevertheless, exports are clearly contracting whereas in the first half of 2008 they were growing by close to 20%. Indeed, the slump in exports is now more severe than in the wake of the 1998 Asian crisis. While temporary factors such as lower commodity prices and a contraction in trade credit will have contributed to the fall in export demand, the scale of the recession now evident in China's trading partners mean that exports will remain under pressure. Exports will also have been affected by the CNY exchange rate. While CNY appreciation against the US$ has halted in recent months, in trade-weighted terms it has still risen, particularly via its strength against the euro and other emerging Asian currencies. We expect the CNY to continue to appreciate and, coupled with the drop in external demand, this will contribute to a fall in export volumes of close to 8% this year. But over the longer term, given its cost competitiveness, China will continue to gain market share.

Imports fell by over 40% in January-February relative to the same period last year, the sharpest drop since the difficult period of adjustment in the late-1980s, suggesting that domestic demand growth has slowed rapidly. The large drop in imports in recent months is also partly related to a sharp dip in import prices (the unit value of imports fell by 18% in February) most likely owing to the appreciation of the effective exchange rate and falling commodity prices. While the drop has moderated recently with a fall of 25% in March, imports continue to be weak. Net trade has contributed over 3% to GDP growth in the last few years but in 2009 Q1, net trade detracted slightly from growth. With a large fiscal package focused on infrastructure investment and increases in bank credit, a strong recovery in investment should feed through eventually to strong imports. World trade growth will continue to be subdued next year so we expect the boost from net trade enjoyed in recent years to continue to disappear over the next two years.

China was fairly immune to the 1998 Asian crisis but is now a much more open economy, both in terms of trade and FDI flows so this time the slowdown in external demand may have more of an impact. China has often been labelled a 'world assembler' with its large and cheap labour force used to assemble imported inputs into final goods to be sold aboard. This role may explain why changes in external demand had little impact on growth in China – any change in exports was offset by a change in imports. But in recent years China has moved up the value chain in terms of its exports and domestic production capabilities have expanded, helped by large FDI inflows. Studies have shown that China's trade balance has become more sensitive to external shocks both positive and negative[2]. Over the past three years, China has enjoyed a large positive contribution from net trade as growth in its trading partners has generally been strong. But this could mean that it will be more exposed to the global downturn than previously. Net trade is soon likely to start subtracting more substantially from GDP growth given the likelihood of much stronger domestic demand growth than in the rest of the world.



Near-term prospects will depend on private investment

While the outlook for net trade will clearly play an important role, prospects for growth in China will be largely related to the factors driving domestic investment and private sector investment in particular. While the majority of investment is 'self-financing' (around 70%), loans from the banking sector make up the most significant source of external finance at 20% (with capital transfers from the government budget (6%) and foreign investment (4%) the remainder). But bank loans have become relatively more important to private companies since the 1990s, with the liberalisation of the banking sector and the official recognition of the role of private enterprises at the 15th Party Congress in 1997. Meanwhile, state-owned enterprises have become much less important for both employment and output.

In 2007, growth in total CNY loans remained strong at close to 17%. But over the course of 2008, there was a slowing in the growth of credit to around 14%. With inflation averaging about 6% over this period, the contraction in real credit growth was more pronounced. This will have affected private enterprises in particular. But the government has scope to promote credit growth to private enterprises through state-owned banks and has outlined its commitment to increasing the availability of credit to all corporations. Recent evidence suggests it has been successful – growth in CNY loans has been very strong this year with an increase of 29.8% in March (24.4% in February). But key issues are whether the growth of credit will feed through to private firms and whether it will be used to finance profitable investment opportunities. The profits of large industrial enterprises fell by 37% in 2009 Q1 which illustrates the current pressure on profitability.

The People's Bank of China has set a target for broad monetary growth (M2) of 17% for 2009 (up from 15% in 2008). With prices falling (the consumer price index dropped by 1.6% in February), the implied real impulse will be significant. And with government investment set to pick up, GDP growth could be stronger than expected this year if the credit stimulus is successful in creating a quick bounceback in private investment. We expect real investment growth to slow to close to 5% for 2009 as a whole, from around 8% in

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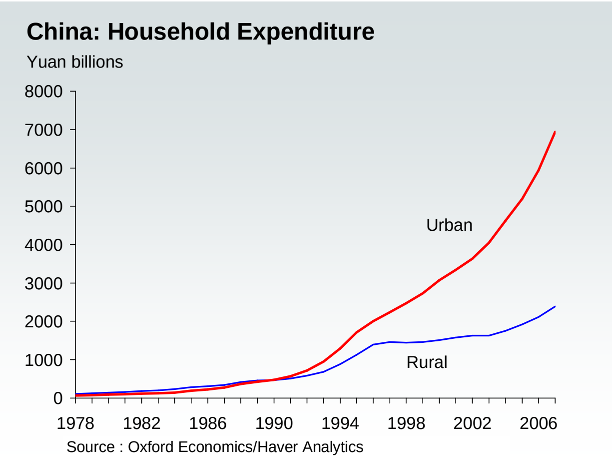
[2] *See Li, C. and Syed, M. (2007), 'The Shifting Structure of China's Trade and Production', IMF Working Paper no. 214*

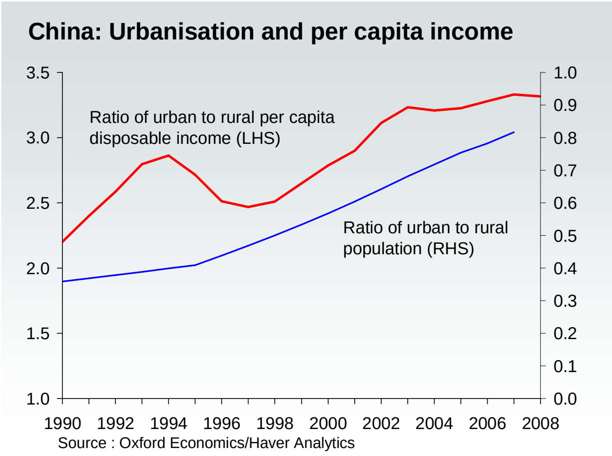
2008, but we expect it to pick up steam towards the end of this year to reach growth of 9% next year.

But one major risk to the outlook is that of a more fundamental restructuring of the banking sector. Official estimates of non-performing loans are relatively low but the true level is likely to be higher and there is general agreement that the banking sector is undercapitalised. So if the slowdown is severe and many of the current new loans go to companies that are less profitable or in particularly vulnerable sectors, then this could trigger a sharp rise in non-performing loans later on, which in turn might force the government to restructure the banking system. While a high level of savings and a large current account surplus gives the government plenty of resources to meet this contingent liability, the process could be destabilising.

Medium term prospects will depend on the behaviour of households

With regards to private consumption this appears to have held up well so far. Nominal retail sales grew by 14.7% in March, broadly flat from Jan-Feb. Given the 1.2% fall in inflation in March, this implies growth in the volume of retail sales only moderated modestly from 19.0% in December. But the consumption of durables has been more affected by the slowing housing market and global financial crisis. Sales of passenger cars fell by 8% in December (and overall sales growth in 2008 was the slowest in 10 years). However, passenger car sales rose by 10% in March suggesting some of the cut in retail taxes on small cars and subsidies for rural vehicle owners may be having an effect. But the near-term prospects for consumption will be driven mostly by the strength – or lack of it – of employment and wage income. With a sharp slowing in growth, the increase in unemployment is likely to be higher than the modest rise in the official measure of urban registered unemployment to 4.2% suggests. But firms may also respond to slowing demand by withholding wages. This would weigh on household incomes, particularly rural households, which depend on remittances from migrant workers. We expect consumption growth to remain fairly strong this year at around 8%, with real incomes supported by strong government transfers and falling prices, but there are significant downside risks to this forecast if unemployment rises sharply.



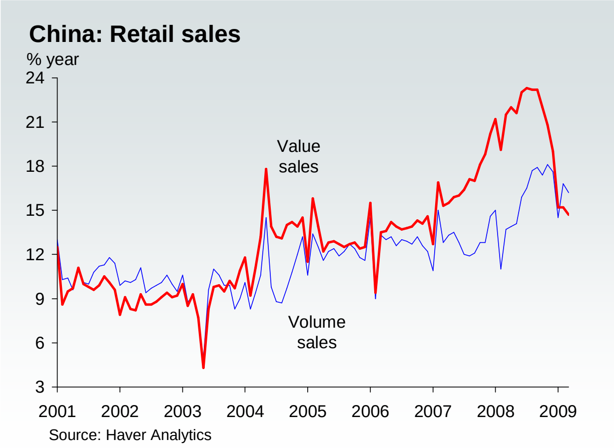


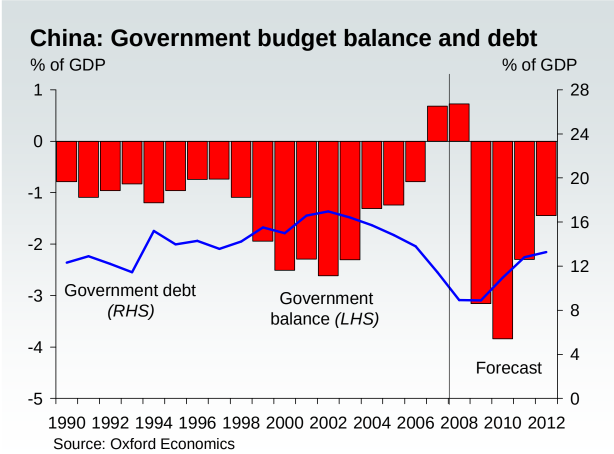
However, the medium-term prospects for consumption (and ultimately overall growth) in China will be driven by the saving patterns of households. Consumption as a proportion of GDP in China has fallen from around 50% in 1990 to below 40%. This is in contrast to other major economies such as the UK, Japan or Germany where the proportion is close to 60%. Why does China have such a high savings rate and why has it been rising over recent years as incomes have risen? One of the most important developments for households has been the increase in urbanisation. Employment in urban areas has grown rapidly with the increase in foreign direct investment and the development of private enterprise. There has been a vast amount of migration from rural areas to urban areas and the ratio of urban to rural population has increased steadily since 1990. While household expenditure has increased rapidly for urban households, the savings rate remains high.

The average savings rate of urban households rose from 17% in 1995 to 24% in 2005[3]. What factors underlie this? There are four to highlight:

- First, the breaking of the 'iron rice bowl' through the restructuring of state-owned enterprises and the low levels of government spending on health and education have driven an increase in precautionary household savings. Pension provision has fallen and the costs of education have increased sharply.
- Second, as more of the housing stock has been privatised, consumers have had to save more in order to secure houses.
- Third, the lack of development of financial markets will also have played a role. Most households do not own homes and for rural households there is limited ability to trade land rights but land cannot be used as collateral so borrowing constraints are widespread. The low return on bank deposits and limited access to other types of savings instruments means that households need to save more to maintain the same level of real wealth.
- Fourth, precautionary savings are likely to be high in the face of uncertainty following the extent of the restructuring of SOEs and the pace of market-oriented reforms.

However, with planned increases in social spending by the government, households are likely to start to reduce their high savings rate, particularly if over the medium term growth is strong and stable. But there are considerable risks in the short term, as households could decide to continue to increase their rate of savings in the face of greater economic uncertainty and the global slowdown.





Will the government's fiscal package maintain growth over 8%?

In the near term, prospects for private demand are weak, but the government has been implementing measures to support economic growth in the face of global slowdown. In addition to the fiscal package outlined below, the key lending interest rate has been cut by 216bp since early September and previous restrictions on access to credit for businesses and households (particularly mortgages) have been made less onerous.

Towards the end of last year, the State Council provided more details on its massive CNY4 trillion fiscal package. While the headline package at close to 15% of GDP sounds enormous, the government has not

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[3] *Chamon, M. and Prasad, E, 'Why are the savings rate of urban households in China rising?', IMF Working Paper No. 145*

made clear how much of this is new spending above and beyond previous commitments in the FY06-10 Five-Year Plan. Some of this ambiguity is deliberate as the government attempts to shore up confidence and minimize unrest in the face of rising unemployment. We estimate that only around a quarter represents new spending which is nonetheless still an impressive boost and does not include the sizeable credit stimulus as well.

With a fiscal surplus estimated at close to 1% of GDP in 2008, an ever-increasing current account surplus and close to US$2 trillion in foreign exchange reserves, the government has plenty of resources at its disposal. While the fiscal deficit is likely to rise to 3% this year, with high potential GDP growth there is scope for China to run much larger deficits if needed. Central government has only committed to CNY1 trillion of the spending with the rest (75%) to be spent and financed by local governments. This represents a welcome shift in spending towards rural areas where health, education and pension provision has lagged behind that in its urban counterparts.

The majority of the CNY4 trillion fiscal package is on major infrastructure investment, with almost half allocated to higher transport spending. But there are questions about the absorptive capacity of the economy for such large-scale infrastructure investment over a short period of time. For this reason, we expect the government package to come on stream more slowly, with some of its impact on growth felt next year. We estimate that the fiscal package will boost GDP growth by around 1% this year and 0.7-1.5% next year. Half of the impact will come from an increase to government investment and half from an increase in government consumption and transfers.

With potential growth close to 9% and a per capita GDP that remains below countries such as Armenia and Albania, over the longer term there is still plenty of scope for large-scale infrastructure projects, but in the near term there will be capacity constraints. So we now expect GDP growth for 2009 as a whole to slow to just over 6%. Growth will then pick up steam, quickly rising to 10% by end-2010 as the government package kicks in and as domestic demand recovers.

While the plan included little by the way of increases in government consumption, more recent announcements have been focused on boosting rural incomes and higher spending on health, including CNY850 billion to be spent by 2011 to provide basic medical insurance for at least 90% of the population. We expect more of a rebalancing away from government investment towards supporting both domestic and government consumption over the next few years. An increase in health and education spending should help to reduce China's high savings rate over the medium term and support private consumption.

Details of government CNY4 trillion fiscal package

Transport Infrastructure	1800 billion yuan
Reconstruction	1000 billion yuan
Rural infrastructure and standard of living measures	370 billion yuan
Housing projects for low-income earners	280 billion yuan
Biological conservation and environmental protection	350 billion yuan
Technical innovation and industrial restructuring.	160 billion yuan
Healthcare, education and cultural undertakings	40 billion yuan

But could growth below 8% bring instability?

A widespread view is that growth of 8% is needed to maintain stability in China and that the sharp slowdown under way and resulting job losses could lead to unrest and demonstrations.

But what is significant about the supposed 8% 'minimum acceptable' level of growth? What matters is the type of growth and whether it can generate enough employment for the abundant labour supply in China and for rural migrants to the cities who often support large households in rural areas. Official unemployment figures are only available for urban areas and for those registered there (migrants are not covered). While even this measure has risen recently to 4.2%, most commentators agree that before China entered the current slowdown, underlying unemployment was at low levels. Unemployment is estimated to have fallen by 4 percentage points in 2000-05 and, with growth well above trend since then (until 2008 Q4), unemployment will have fallen further. So while unemployment has increased recently, and is likely to rise further, it is doing so from low levels. Companies are also likely to hoard labour and reduce wages, but the consequent fall in incomes may not be enough to lead to significant calls for social change.

The last time protests threatened the stability of the political system in China was in Tiananmen Square in 1989. It is true that high unemployment among graduates contributed to those protests but this was during a period of radical restructuring of state-owned enterprises as well as coming at the end of a period when it appeared that the Communist Party was gradually relaxing its grip on the country's political development (very unlike the situation in recent years). With the current slowdown more cyclical in nature, we may see less of a rise in structural unemployment. Over recent years, China has experienced tens of thousands of smaller protests and, while the number of protests is likely to have risen, for these to be destabilising there would need to be large protests in urban areas with some degree of coordination. The younger generation would also likely need to be heavily involved, but in recent years student protests have tended to be nationalistic in nature. The younger generation that has only known a market-oriented economy and little discussion of politics may not be as inspired to protest as the Tiananmen Square generation. The government has also shown both a commitment to maintain order (internet censorship has increased) and a willing to appease protesters through government transfers. But there are potential flashpoints with several significant dates this year including the 20th anniversary of the Tiananmen Square protests in June and the 60th anniversary of the formation of the People's Republic in October. With many migrant workers likely to lose their jobs and hence their ability to support families back home, social unrest could result if unemployment rose sharply and growth stagnated.

Conclusion

A turn in the domestic investment cycle has been coupled with a dramatic slowdown in external demand, leaving China weathering storms on both fronts. But with the government stepping in with an unprecedented fiscal package and with fewer structural problems to contend with than in previous downturns, China is likely to fare better than in the sharp slowdowns of the early 1980s and 1990s. So while we now expect growth to slow to close to 6% this year, growth will pick up steam quite soon, quickly rising to 10% by end-2010. Indeed, some green shoots of recovery are already emerging with a pick-up in manufacturing new orders and strong growth in credit. Growth could rebound sooner if the government package and credit stimulus is successful in quickly refuelling domestic demand. But there could be a more serious downturn if the fiscal package fails to keep investment growth from falling dramatically and if unemployment rises rapidly, leading to both a slump in consumption and an increase in social tensions. There are other downside risks; with many major trading partners falling into severe recession, Chinese exporters could face an increase in protectionist measures that would constrain their ability to gain export market share, while an increase in loss-making investments could trigger a more fundamental restructuring of the banking sector.