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Is China's Slowdown for Real?

Introduction

In recent months, China's economy has been showing signs of slowing down. The country's GDP growth rate fell below 9 per cent in the third quarter of 2011. Although the reversal of the growth trends is only marginal, it has nonetheless made news because such a trend has not been seen for quite a while. What is more significant is that the top Chinese leadership has confirmed the news of the slowdown. Prime Minister Wen Jiabao announced in the National People's Congress that China's economic growth target was reduced to 7.5 per cent from an 8 per cent goal in place since 2005. The question that is being asked now is whether the Chinese economy is headed for a "hard landing", something that Paul Krugman, among others have been arguing about for the past few months (Will China Break?, New York Times, December 18, 2011).

Various analysts and international organisations like the IMF, the ADB, the World Bank and the OECD have been downbeat about the growth prospects of China's economy during 2012. All these agencies have been predicting that China will grow at rates close to 8 per cent. IMF's assessment is that the China's growth will fall even further if the euro zone goes into a deep recession. For example, the IMF warned against a 4.2 per cent growth in China in 2012, if a sharp recession struck the euro zone.

In the past, authenticity of official GDP data has often been questioned, for there exists a view that these numbers are "man-made, and therefore, unreliable".1 There is therefore a need to look at other indicators in order to make better assessment of the present state of the Chinese economy. One such indicator using which a more realistic picture of China's growth trends can be seen is the demand for capital goods. Since the third quarter of 2011, China has been cutting its demand for a range of capital goods, thus contradicting the GDP figures.

Factors Indicating a Slowdown

Other economic indicators in China also point that the danger of an economic downturn in China still looms large. Since the third quarter of 2011, China has been cutting its demand for a range of capital goods, thus contradicting the GDP figures. This strongly indicates that there is a need to look at the internal factors such as the industrial growth and domestic investments as well as external influences to economic growth, in particular, international trade.

Internal Factors

The country's manufacturing activity contracted in November for the first time in almost three years, and the downward trend has continued since." According to the National Bureau of Statistics of China (NBS), industrial production growth rate in 2011 was 13.9 per cent compared to 16 per cent in 2010. The growth rate of value added industrial production for January-February 2012 is reported to have fallen to 11.8 per cent year-on-year.

The latest trend of Chinese manufacturing growth in 2012, as indicated by the Purchasing Managers' Index (PMI), also shows a contraction in manufacturing activity. The PMI is a gauge of nationwide manufacturing activity collected through a survey of purchasing managers in

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[1] Wikileaks cables quotings senior government functionary.

Table 1: Various Estimates of China's GDP Growth (in %) in 2012

	ADB	IMF	World Bank	OECD
Baseline	8.8	8.25	8.4	8.5
In case of Euro Zone Downturn	-	4.2	-	-

Sources: Asia Economic Monitor, ADB (Dec. 2011); World Economic Outlook, IMF (Jan 2012); ; Global Economic Prospects, World Bank (June 2011)

the manufacturing sector on five different fields, namely, production level, new orders from customers, speed of supplier deliveries, inventories and employment level. A reading below 50 indicates contraction from the last period.

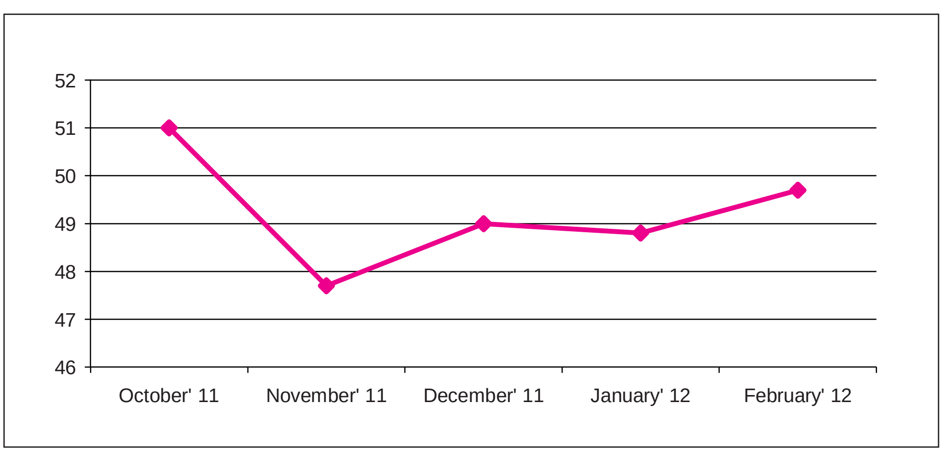
Figure 1 shows the trajectory of manufacturing activity captured by the PMI for the last five months in China. Since October 2011, the manufacturing sector has been experiencing a contraction with the PMI falling from 51 in October 2011 to 47.7 in November 2011.

In addition to the overall contraction in manufacturing activity in China indicated by the index, there are other indicators captured while constructing the index that measure different aspects of manufacturing activity. The PMI for January 2012 for China, according to HSBC/Markit, was 48.8, down from PMI of 49 in December. While the PMI for February improved slightly to 49.7. However, the slump in the new export orders continued with the PMI for new export orders falling from 50.4 in January 2012 to 47.5 in February. A contraction in new business orders in February 2012 is reflective of a lack of domestic demand. The HSBC/Markit PMI closely tracks light industrial production tied to the export sector, whereas the China Federation of Logistics and Planning (CFLP) PMI better tracks heavy IP aimed at final demand (Roubini Global Economics, RGE: March 1).

According to the CFLP, the PMI improved in February to 51 from 50.5 in January. New business orders as well as export orders also improved between January and February. However, the index of new orders in metal products and smelting of ferrous metals posted a decline in February. Around 40 per cent of domestic steel production in China is absorbed by real estate sector. Thus, this is reflective of the slowdown in property sector which has also been taking a toll on the home products manufacturers and retailers. According to reports, Saint Gobain, a Fortune 500 company shut down all its seven home decoration shops in Shanghai in 2011 to avoid losses.

The fall in the domestic manufacturing activity in China is also evident from its falling demand for raw materials and intermediate goods. For example, Australian iron-ore miners

Figure 1: HSBC Purchasing Manager's Index for China's Manufacturing Sector



Source: HSBC Emerging Markets Index.

have witnessed a fall in their exports of iron ore, a key ingredient in steel making firms oriented towards China in the recent period. Also, the domestic dealers of the German luxury car company Daimler AG has been giving away lavish discounts on its high-end as well as entry level models of Mercedes in China. Therefore, the effect of a slowing economy and weakening manufacturing in China can be seen on the weakening of spending domestically.

According to the RGE, "Chinese growth is bottoming out or at best, very slowly rebounding". Industry contributes 47 per cent of the total GDP of China; hence, a slowdown in this sector will have a significant effect on the overall economic growth.

The second most important sector in terms of contribution to China's GDP is the services sector which contributes about 43 per cent to GDP. According to official statistics, services sector grew at the rate of 8.9 per cent in 2011, less than the near 10 per cent growth in 2010. The latest figures on services sector growth given by the non-manufacturing PMI also do not show any sign of expansion in services sector. The CFLP non-manufacturing PMI in January fell to 52.9 from 56 in December 2011. Agriculture, on the other hand, that contributes the rest 10 per cent of GDP grew at 4.5 per cent in 2011, roughly the same as in 2010.

The weakening of demand from developed countries as well as the slowdown of the domestic real estate sector has shown effects on the growth of China's domestic economy. The rising inflation and monetary tightening has led to a slowdown in domestics investments. Growth of domestic investments, according to the NBS, was 23.8 per cent in 2011, down from 25 per cent in 2010. For January-February 2012, the year-on-year growth rate of investments in fixed assets in industrial sector as a whole fell to 21.5 per cent.

External Factors

However, the pull-down factors for economic growth in China are not only internal, but also external. The other force that has determined economic growth in China for a long time has been international trade which has been significantly affected by the euro zone debt crisis. To sustain the high growth of export-oriented industrialisation, China's appetite for raw materials, intermediate and capital goods grew tremendously.

China relies heavily on imports of these products and has formed a supply chain in its trade pattern, where developing countries like India, Brazil and South Africa have become major suppliers of raw material and intermediate goods to China, while developed countries supply capital goods to the Chinese industries. In turn, China mostly exports capital and consumer/finished products to both developed as well as developing world. With around 10 per cent of total world exports being accounted for by China, which is around US $ 1.5 trillion, it may be viewed as a virtual "factory" of the world, sourcing raw materials and intermediate goods from the developing countries and capital goods from developed countries, and selling the finished capital or consumer goods back to these countries.

However, the trade surplus that China had been enjoying since a long time owing to the export-oriented economic growth fell for the first time since the Asian financial crisis of 1998, from $ 183 billion in 2010 to $ 155 billion in 2011. The latest figures on trade released for February 2012 show a trade deficit of $ 31.5 billion for China. The surge in imports by manufacturing companies to build up their supplies is said to have caused this deficit. The deficit for January

Table 2: Trend in Growth of China's Trade with US in 2010 and 2011

	Value in $ Billion		Rate of Growth (%)	
	2010	2011	2010	2011
Total Trade	456	503	25	10
US Export to China	92	104	32	13
Import from China	364	399	23	9
Trade Deficit of US	272	295		

Source: USITC Trade Database.

and February 2012 combined was about $ 4.25 billion, compared to $ 890 million in the same period last year.

China's trade also slowed down in 2011 with the EU and the US. The latest figures on China's trade with US in 2011 from USITC trade database reveal that the growth rate of US imports from China in 2011 was only 9 per cent while the growth rate in 2010 was 23 per cent. Growth of exports to China from the US also slowed down drastically to 13 per cent in 2011, compared to a 32 per cent growth rate in 2010 (refer to Table 2).

The latest trade data from Eurostat shows that from January to November 2011, Europe-China cumulative trade deficit of EU27 with China was 145.4 billion euros, which fell by 6.4 per cent year on year. This is explained by the fact that countries like Germany, France, Spain, Britain, the Netherlands and other major countries in the EU reported a fall in imports from China in 2011, but a buoyant growth in exports to China in the same period.

There are other indicators that confirm the falling exports of China, such as the slowdown in foreign trade cargo growth in 2011. The total volume of foreign trade cargo from coastal ports in China grew by 11 per cent between January and November 2011, while the rate in the same period last year was around 15 per cent. Freight transported through civil aviation has been hit the hardest, with the growth rate falling from around 25 per cent between January and November 2011 to a negative 1.7 per cent in the same period in 2011.

Conclusion

The weakening of export-led growth strategy of Chinese economy has been putting pressure on the government to relinquish its control over the exchange rate and make yuan fully convertible in the global market. China has initiated steps towards liberalising the capital inflows and possibly towards full convertibility of yuan.

On the domestic front, the major headwind that has been threatening the Chinese economy is the rising property prices and the consequent pressure on the government to increase credit availability as well as supply affordable housing to citizens. The economic stimulus of 2009 infused into the economy that led to a construction boom, surging real estate prices in China has engulfed the Chinese economy in a possible property bubble. However, Chinese have been proactive in taking policy initiatives in the past and thus, it remains to be seen how the China's strategic moves will enable it to evolve out of the internal and external pressures building up. Therefore, China needs to do a balancing act in forming its policies in the immediate future on the domestic and external economic front.

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