RIS Policy Brief
CHINA UPDATES
No. 58 August 2012

China's Economy

Estimates provided by the National Bureau of Statistics of China have shown that the country's economy has slowed in the second quarter of the current year. While in the first quarter of 2012, the Chinese economy witnessed a GDP year-on-year growth rate of 8.1 per cent, in the second, the growth rate fell to 7.6 per cent. Consequently, the growth rate in the first half of the economy grew by only 7.8 per cent as compared to 9.6 per cent in the previous year.

Various international agencies, including the International Monetary Fund (IMF), the Asian Development Bank (ADB), the World Bank and the Organisation for Economic Cooperation and Development (OECD) have also revised downwards their previous projections on Chinese economic growth in 2012 (Table 1). The IMF Managing Director, Christine Lagarde sounded most bearish when she commented that China's economy is likely to grow by less than 8.0 per cent this year.[1]

This development should not come as a surprise to most observers, as the Chinese government has taken deliberate steps over the past several months to cool the economy through tighter monetary policy, curbs on borrowing in property sector and allowing yuan to appreciate against the dollar. Among the measures that were adopted was the restrictions on bank lending to the real estate sector in order to reduce speculation.

As always, doubts are being expressed as to whether the extent of slowdown is being under-reported. Several economists in China have observed that the growth estimates provided by the National Bureau of Statistics (NBS) are not consistent with several other indicators reflecting the health of the economy. Trends in a wide range of indicators lend credence to this view, especially the figures on electricity consumption, which have deteriorated sharply over the past few months.

The causes of this downturn need to be understood, for herein lies the answer as to whether the Chinese economy would get back to the growth trajectory of the past anytime soon. Domestic as well as the external factors need to be analysed in tandem to understand the whole scenario.

Internal Economic Indicators

Slowing down of the industrial sector caused much of the slowdown in China. The sector, which accounts for 45 per cent of the GDP, saw a moderation of growth from 14.3 per cent in the first half of 2011 to 10.5 per cent during the same period in 2012. Growth rate of value added in the services sector also fell in the first half of 2012 to 7.7 per cent, compared to 9.2 per cent in the same period in 2011.

The Purchasing Manager's Index (PMI) prepared by HSBC is also pointing to the decline in the growth rate of the industrial sector. The PMI is a gauge of nationwide manufacturing activity collected through a survey of purchasing managers in 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.

RIS Policy Briefs are prepared to communicate results of RIS research on specific policy issues to the policy makers.

This *Policy Brief* has been prepared by Ms. Ramaa Arun Kumar, Consultant, RIS.

Table 1: Revised Estimates of China's GDP Growth (in per cent) in 2012

	ADB	IMF	World Bank	OECD
Previous Estimates (early 2012)	8.8	8.25	8.4	8.5
Revised Estimates	8.2	Less than 8%	8.2	8.2

Sources: Biannual East Asia and Pacific economic update, World Bank; China - Economic Forecast (May 2012), OECD; and Asian Development Outlook Supplement, July 2012, ADB.

[1] http://www.marketwatch.com/story/imfs-lagarde-sub-8-growth-likely-for-china-2012-07-12

The latest trend in PMI indicates that manufacturing activity has been contracting. Table 2 shows the trend in the PMI for China since November 2011. The overall PMI has been below 50 throughout the first six months of 2012. According to the latest report based on PMI by HSBC, "China's goods producers reported an eighth successive month-on-month deterioration in operating conditions during June, as output, incoming new orders and employment continued to decrease." The steepest fall was observed in the new orders, both from domestic as well as foreign buyers, especially US and Europe. This is cited as the primary reason for the fall in manufacturing activity. However, manufacturing output has fallen at a lesser pace than the new orders. As a result, the inventories have gone up drastically, with the second-largest growth of inventories recorded since this database began to be collected in April 2004.

Input costs such as energy and various other commodities have been falling too, leading to a fall in average costs of production and therefore, the factory outlet price. Whereas, employment level in manufacturing industries has shown deterioration in recent months, with the index falling below 50 for the first time in 2012.

Yet another source that is confirming the decline in the Chinese economy is the monthly OECD composite leading indicators (CLIs) for China. The leading indicators are designed to anticipate turning points in economic activity relative to trend. The CLI system uses the monthly index of industrial production (IIP) as a proxy measure for economic activity. The CLI system focuses on the business cycle, defined as the difference between the smoothed IIP data and its long-term trend. OECD CLIs aim to predict turning-points in this business cycle estimate.

The key feature of the CLIs is that they move in the same direction as do the business cycles, and they, therefore, provide a strong signal of the phase a country is likely to be in its business cycle in the near future.

The CLI data on China given in Table 2 may be taken as an indication that the country is indeed facing a strong slowdown with economic activity falling below long-term trend. The trend in CLIs for China provides a fairly accurate picture of the trend in the economic activity as indicated by the GDP. Figure 1 plots the two data, that is, monthly data for CLI and quarterly growth rates of GDP for China since 2007. The movement in GDP is in tandem with the composite leading indicators.

Table 2: OECD CLI and Manufacturing PMI Data for China

Time Period	CLI China	PMI
Nov-2011	100.1	47.5
Dec-2011	99.9	49
Jan-2012	99.8	48.8
Feb-2012	99.7	49.7
Mar-2012	99.5	48.3
Apr-2012	99.4	49.3
May-2012	99.2	48.4

Sources: OECD.StatExtracts and HSBC Emerging Markets Index.

There are other indicators that also indicate a strong slowdown in China. For instance, according to the NBS, the first quarter GDP growth year-on-year for 2012 was reported as 8.1 per cent while the total electricity consumption growth rate was only 6 per cent for the same period according to the National Energy Administration, China. The heavy industries, which account for more than half of the total energy consumed in industrial sector, witnessed a paltry 3.8 per cent growth rate for the first quarter.

The slowdown in the domestic economy can also be measured by the growth of total volume of freight movement by the railways. According to NBS data, the total turnover volume of freight transported through railways grew much slower in the first 5 months of 2012, compared to the same period last year. Table 3 gives the growth rates for January to May for 2011 and 2012. The growth rate for all months in 2012 grew much slower than that in 2011. The overall growth rate for the period of five months in 2012 was 3.1 per cent, whereas the same for last year was 5.9 per cent. This clearly indicates and reinforces the point that economic activity has substantially fallen in China.

The external factor of growth would now be looked at to assess the pace and extent of economic slowdown in China.

Table 3: Growth Rate of Total Freight Movement by Railways in China (in Percentage)

Time Period	2011	2012
January	1.6	1
February	7	5.1
March	7.3	1.7
April	5.4	3.3
May	5.5	2.2
January to May	5.9	3.1

Source: National Bureau of Statistics, China.

External Economic Factors

Economic weakness has also permeated into the international trade front in China, with a weak growth of exports as well as imports in the recent months. The latest exports for China stood at US $ 180.21 billion in the month of June, which increased by 11 per cent, year-on-year, according to the General Administration of Customs (GAC). Imports, on the other hand, rose to $ 148.8 billion with a growth rate of just 6.3 per cent.

Although exports have picked up pace in the recent months after February when China faced a negative trade balance for the first time after the financial crisis of 1998, the pace of growth has not been very strong. Exports in May stood at $ 181.1 billion, around 11 per cent growth since April 2012. The trade balance, however, has been rising in the recent months with exports rising at a faster pace than the imports. June witnessed a fall in both exports and imports. However, imports fell more than exports at the rate of 8.5 per cent since May, as a result, trade surplus rose to $ 31.7 billion for the month of June.

Table 4: Monthly Trade Data of China for 2012

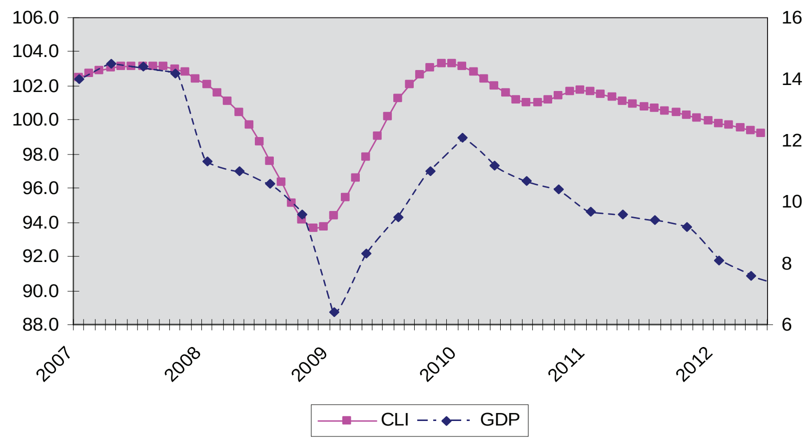
(in US $ Billion)

Time Period	Exports	Imports	Trade Balance
January	149.9	122.6	27.3
February	114.4	145.9	-31.5
March	165.6	160.3	5.3
April	163.2	144.8	18.4
May	181.1	162.4	18.7
June	180.2	148.5	31.7

Source: Ministry of Commerce, China.

The recent spurt in trade has been brought about by a slight increase in demand from the US, while that from the EU has remained low. In the first half of 2012, the US took over as the largest trading partner to China from the EU, with China's exports to the U.S. rising at 13.6 percent year on year to US $ 165.32 billion, compared with a less than 1 per cent increase to US $ 163.06 billion to EU. As a result, US trade deficit with China has increased by 10.2 per cent

Figure 1: Comparison of OECD CLI and GDP of China since 2007



Sources: National Bureau of Statistics, China for GDP figures and OECD.StatExtract for CLI.

in the first five months of 2012 compared to the same period in 2011.

Can the Trends be Reversed, and If So How Soon?

While the causes of the declining growth rates are of immense interest, for they could provide some answers to the question that many would be asking now, would the Chinese economy get back to its earlier path of double or near double-digit growth rates anytime soon?

The Chinese government as well as the People's Bank of China has implemented various measures to stimulate growth in the economy in the recent months. These include a series of expansionary monetary policy measures where the benchmark interest rates were lowered two times within a month and the reserve requirement ratio was also reduced.

However, it is being said that the high level of domestic debt has made the expansionist strategy, adopted after the economic crisis, questionable.[2] The local government debt is estimated to be over 10.7 trillion yuan which, the observers feel, if it turns sour in the wake of economic slowdown and slowing property sector can spell a disaster for the economy.

Steps are now being taken by China to strictly regulate the local government debt to prevent risks. Few weeks earlier, the National People's Congress (NPC), a state body and the legislative house in China, removed an article that allows local governments to issue bonds directly, following a trial programme last November. In the new law, the Ministry of Finance can issue bonds on behalf of the local governments in accordance with the laws and regulations set by the state council.[3] Therefore, the route to higher growth for China is not without hurdles.

Also, the emphasis laid by the Chinese premier on enhancing investments and promoting exports to boost the economy is being considered as a step that would aggravate the global imbalance further as it is the domestic consumption that needs to be enhanced by China rather than investments in industries that would produce for exporting their products. This will only help in increasing China's trade surplus, hurting not only the economies of major exporting markets especially the US and EU but also it would not solve the inherent problem in the model of economic growth of China.

The need of the hour for China is to tackle the domestic economic issues. An unbalanced growth may bring the economy down from being an economic might and would deter the country's aspirations of making its currency an international currency, and may be someday a reserve currency too.

[2] Biswajit Dhar, "China's Loss of Momentum". Mint. 17 July, 2012.

[3] Ibid.

RIS
Research and Information System for Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: publication@ris.org.in
Website: www.ris.org.in