

China affects us all

How worried should we be about weaker economic growth in China?

Having enjoyed remarkable growth over several decades, China has become very important to the global economy. Ten years ago the country's GDP amounted to 4.4% of global production. Last year this figure had increased to 13.3% and only the US contributes more to the global production of goods and services. China has a very open economy, with a great deal of import and export activity.

The size of the Chinese economy and its close ties to the rest of the world mean that what happens in China affects us all. It is not just how high the growth rate is, but also which measures the government implements and how these affect the economy. When China devalued the renminbi by 3% against the dollar in August, most emerging market currencies also weakened. This was due to increased scepticism around the development of the Chinese economy and the effect a Chinese downturn will have on emerging market countries that produce raw materials for the Chinese. In addition, people wondered whether this was just the first of several devaluations by the Chinese to prop up GDP growth.

Wary of authorities

According to Chinese officials the country's GDP grew by 7% from the first half of last year to the first half of this year. Many are sceptical of this figure. The government set a target for the economy to grow by, yes, 7% this year. It seems, to put it mildly, slightly suspicious that statisticians are serving politicians a quick win.

Other figures, which do not have the same symbolic value as GDP growth, indicate that growth is lower. Imports fell by 6% in the 12-month period from June last year to June this year, while exports were up only 2.7%. This indicates slower growth in domestic consumption of goods and services, as well as significantly lower growth in global demand for Chinese-made goods and services. Both these things are difficult to reconcile with GDP growth of 7%.

Moreover, official figures for industrial production have great symbolic significance. They indicate that annual growth so far

this year has remained at around 6%. But activity indicators, produced both by the Chinese authorities and the international financial information services company Markit, suggest that industrial production is roughly at a standstill.

Five percent growth

The current Prime Minister of China said some years ago that the official GDP and industrial production figures were not to be trusted. He believed the focus should be on credit, electricity production and railway transport volume. Based on these measures, the growth rate in China is only 3%. The weakness with this gauge is that it does not capture the growing importance of the provision of services. Over the past two years, this has constituted a larger share of GDP than industrial production and the construction sector.

The importance of the provision of services may well be far greater than official statistics indicate, and not only because the Communists have a penchant for industrial workers. It is difficult to capture the importance of new economic activities. PMI data for service indicates that growth has remained at roughly the same level for the past three years.

When all is said and done, I believe that growth in the Chinese economy is around 5%, which tallies with investors pricing of global assets.

That economic growth slows as a country gets richer is completely natural. One first picks the lowest hanging fruit, which does not require much capital. Eventually one gets less and less in return on new capital. Trend growth can still be kept at a reasonably high level, but it requires further market economy reforms, such as the privatisation of the large state-owned companies. Here the Chinese government has indicated some willingness, but so far little has been done.

Devaluation is best weapon

Although trend growth will remain well above 5-6%, there is a danger that China is facing a cyclical downturn. Many of last year's investments have not been profitable. Debts have piled up, particularly

in local government, which may become difficult to service. A sharp fall in investments and a dwindling of consumers' faith in future income may pull real growth down further. This will create negative repercussions for the global economy.

So what will the government do to get the economy out of recession? From experience, they will probably try fiscal measures. But economic history has shown that fiscal policy is poorly suited to getting the economy out of a trough.

Monetary policy is more effective. Interest rates are, however, already quite low in China, so there is not much to go on. Further loosening the reserve requirements of banks, which have a function in China, may stimulate increased lending. The greatest effect will probably come from writing down the value of the renminbi, however. This stimulates exports and skews domestic demand towards own goods and services. They probably have quite a lot to go on before there is a risk of inflation – at just 1.6% – running riot.

China has for several years grown more than its trading partners, and this has strengthened the renminbi. In trade-weighted terms, the Chinese currency was 8% stronger than a year ago by the end of September.

If China does end up slipping into recession, we should probably be prepared for a far weaker renminbi. Then it will be a matter of correctly assessing what consequences this will have on the global economy and asset prices.



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