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China's Suspect Economic Data

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China has again announced fast growth with low inflation. And again, the PRC will be widely praised as a future, or even current, economic superpower. Other facts have not changed, however, and in these instances stability is not a laudable goal.

Once more, there are inconsistencies in the most basic and prominent official Chinese data. To the extent official data are reflective, persistent imbalances within the economy are no smaller and may be worsening. The loan stimulus so effective in pushing the PRC past an economic rough patch has now faded. Growth, while still strong, is waning as the stimulus fades, highlighting another round of damage inflicted on the financial system.

What Is Real? China's GDP officially rose 11.1 percent on-year in price-adjusted terms in the first six months of 2010 to almost $2.54 trillion. As expected, second-quarter growth decelerated, to 10.3 percent. The consumer price index rose 2.6 percent, completing a picture of slower but still rapid growth along with contained inflation.

A second glance is troubling, though. The arithmetic comparison of GDP through June 2010 to GDP through June 2009 shows a nominal 23.6 percent gain. The difference between nominal and price-adjusted, or "real," growth is the GDP deflator. The deflator measures price increases at 12.5 percent, sharply at odds with consumer inflation.[1]

An explanation is in China's data revisions. Beijing issues economic numbers only two weeks after a quarter ends, an impossible feat in the world's most populous country. One correction for the premature data is supposed to be revisions, but these have not been helpful. China only revises GDP growth higher and does not revise most of its other figures, so revisions render most statistics on the Chinese economy incomparable.

The 2009 revisions seemed better. Overall GDP growth was raised, again, from 8.7 percent to 9.1 percent but, for the first time, quarterly breakdowns were provided. These show higher GDP in the first half of 2009, lower on-year nominal growth of 16.7 percent for 2010, and a reasonable GDP deflator of 5.6 percent.

It seems odd, however, for such a small revision to real growth to correspond with such a dramatic change in the deflator. It turns out that, although the revisions entailed a sizable decrease in the initial level of GDP for the fourth quarter of 2009, there was no corresponding decrease in real growth for the quarter. One way to represent that disparity is a considerable and convenient after-the-fact reduction in the GDP deflator. It may be that China simply moved an important statistical discrepancy away from the spotlight.

Unbalanced Economy. Prices also influence the major components of GDP. The State Statistical Bureau provides poor measurements for investment and consumption, releasing better indicators less

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frequently and very late. Fixed asset investment rose 25 percent to near $1.68 trillion—equal to almost two-thirds of GDP, a ratio that climbs as the year goes on. Investment growth is nominal, and real growth would be lower by an unspecified amount.

Retail sales—the official benchmark for consumption—were said to gain 18 percent to $920 billion. Nominal sales growth was near 24 percent (unrevised). While this matches investment, the gap between the sizes of investment and of consumption in the first half of the calendar year has ballooned past $750 billion. Stimulus was investment driven and worsened this imbalance. There are also powerful reasons at the sector level to worry about comparatively inadequate consumption, despite its robust growth.

Autos are held up as a stunning consumer success, yet demand cannot match supply. As incentives expire, sales growth is well short of output: sales gained over 30 percent in the first half of 2010 to near 7.2 million units, while output surged almost 45 percent to near 8.5 million units. There may also be more data issues. Passenger vehicle sales soared 77 percent in the first quarter, but gasoline demand edged up only 3 percent.[2]

Other areas of oversupply are well-known. Steel overcapacity is close to 250 million tons, while retrenchment plans address only 25 million tons. Domestic overcapacity in cement is headed past 1 billion tons. Consolidation of cement, autos, and other industries have sputtered, as the primary goal is to enhance the position of selected state firms rather than curb capacity. Heavy industry is the top user of electricity, so it is no surprise that first-half electricity consumption rose over 21 percent—twice as fast as GDP—past 2 trillion kilowatt-hours. Industrial consumption rose 24 percent and comprised three-fourths of this first-half electricity use.[3]

In the financial equivalent of overcapacity, real estate has an unsustainable role in the economy. The ratio of the housing stock as compared to GDP is higher than the U.S. in 2006, before the bubble burst. Yet in the first quarter of 2010, loans for property were nearly a third of total lending and growing twice as fast. For the first half as a whole, real estate investment expanded 38 percent, easily outrunning overall investment, which was itself too rapid. The value of land purchases skyrocketed 84 percent.[4]

Financial Harm. Properly speculation ties immediately to banks. The financial system was unsound before the crisis. Pre-crisis estimates of government aid to banks ranged up to $650 billion. And this solved only the easy problem. Banks still routinely made, then hid, non-commercial loans. In September 2009, the Ministry of Finance itself did the same on a vast scale, rescheduling a $36 billion bond held by giant China Construction Bank (CCB), which accounted for half its net assets. Cinda Asset Management sold the bond to help absorb CCB's bad debts, then survived on handouts from China's central bank. CCB can claim adequate capital but only due to yet more government assis-

1. Sheng Laiyun, "National Economy Showed Good Momentum of Development," National Bureau of Statistics of China, July 15, 2010, at *http://www.stats.gov.cn/english/newsandcomingevents/t20100715_402657420.htm* (July 15, 2010); National Bureau of Statistics, China Monthly Statistics, Beijing, Vol. 7, 2009.
2. Xinhua, "China's 1H Auto Sales Slow as Inventory Rises," July 5, 2010, at *http://news.xinhuanet.com/english2010/china/2010-07/05/c_13384519.htm* (July 15, 2010); Liam Denning, "China's Thirst for Oil Could Come Up Short," *The Wall Street Journal*, June 1, 2010, at *http://online.wsj.com/article/SB10001424052748703957604575272803585420796.html* (July 15, 2010).
3. Xinhua, "Chinese Official Warns of Overcapacity Amid Industry Recovery," December 3, 2009, at *http://news.xinhuanet.com/english/2009-12/03/content_12580920.htm* (July 15, 2010); Business Wire, "Research and Markets: 2009 Chinese Cement Production Amounted to 1.63 Billion Tons, a Rise of 17," March 11, 2010, at *http://www.allbusiness.com/economy-economic-indicators/economic-indicators/14090526-1.html* (July 15, 2010); Xinhua, "China's Power Consumption Rises 14.14 Pct in June," July 14, 2010, at *http://news.xinhuanet.com/english2010/china/2010-07/14/c_13399406.htm* (July 15, 2010).
4. *China Daily*, "Chinese Banks Ramping Up Agricultural Lending This Year," April 21, 2010, at *http://news.xinhuanet.com/english2010/china/2010-04/21/c_13260692.htm* (July 15, 2010); National Bureau of Statistics of China, "Operation of the National Real Estate Market in the First Half Year of 2010," July 13, 2010, at *http://www.stats.gov.cn/english/newsandcomingevents/t20100713_402656868.htm* (July 15, 2010).

tance. The largest state bank, Industrial and Commercial Bank of China, holds $46 billion in bonds of the same type.[5]

Enter the $586 billion stimulus program. Provinces were to spend two-thirds, but many wanted far more. A few weeks after the stimulus was announced, provincial spending plans reached $1.47 trillion.[6] By law, local governments cannot report budget deficits, so the stimulus had to come largely through banks. Official data have local government debt in 2009 alone rising 70 percent to $1.08 trillion, or over 20 percent of GDP. In comparison, 20 percent of American GDP is $2.8 trillion—two years of current federal deficits. Beijing attacked local borrowing, but more still occurred in the first half of this year. Just a partial government audit found seven provinces with larger debt than annual revenue.[7]

Finally, since 2007 banks have transferred loans to investment trusts, moving them off their own balance sheets. Transfers were banned at the end of June 2010, but an estimated $300 billion in assets were moved in the preceding nine months alone. Banks do not hide excellent assets, and the ultimate rate of failure for transferred assets may be high.[8]

Lack of transparency clouds the question of system solvency, but there are hints. In early spring—before the damage was finished, much less tallied—the four largest listed banks needed $70 billion in fresh capital. Chinese banks chiefly raise money, through rights offerings or subordinated debt, from other Chinese banks. For the past decade, smaller banks grew faster than the large listed banks.[9] Faster lending in a slower economy generally makes for weaker balance sheets. And larger banks have received far more government aid. The large listed banks may be turning to even shakier allies for help.

More ominous is that the government, too, seeks funds. Many government bank stakes are held in an entity known as Central Huijin, which will assist with banks' needed fundraising. But Central Huijin has to raise capital to buy bonds and stock from its charges.[10] The main purchasers of its bonds will be banks themselves. The central government is turning for capital to a system turning to the central government for capital.

Silver Lining? To be clear, there is no imminent crisis. Bad debts will accrue this year and next. They should appear on bank books in 2011 and 2012, and the inevitable bailout will start no later than 2014. The wisdom of the stimulus cannot be fully judged until then.

For now, a slower economy suffering financial strain may turn Beijing toward enhancing prosperity

5. Andrew Peaple, "The Chinese 10-Year Plan for Bad Debt," *The Wall Street Journal*, September 23, 2009, at *http://online.wsj.com/article/SB125361482592230449.html* (July 15, 2010).

6. *The New York Times*, "What the Chinese Stimulus Package Means," November 23, 2008, at *http://www.nytimes.com/2008/11/23/business/worldbusiness/23iht-yuan.3.18074260.html* (July 15, 2010)

7. Andrew Batson, "A Window onto Local Government Debt in Tianjin," China Real Time Report, June 9, 2010, at *http://blogs.wsj.com/chinarealtime/2010/06/09/a-window-onto-local-government-debt-in-tianjin* (July 15, 2010); Business China, "China Auditor Warns over Local Government Debt Risk," June 24, 2010, at *http://en.21cbh.com/HTML/2010-6-24/0MMDAwMDE4MzY0MQ.html* (July 15, 2010).

8. Dinny McMahon, "China's Banks' Loan Tactic Raises Transparency Issues," *The Wall Street Journal*, December 17, 2009, at *http://online.wsj.com/article/SB10001424052748703323704574601720742255060.html* (July 15, 2010); Reuters, "Update 2—China Takes Aim at Off-Balance Sheet Lending—Sources," July 5, 2010, at *http://www.reuters.com/article/idUSTOE66403I20100705* (July 15, 2010).

9. Luo Jun, "ICBC Says China's Big Banks Need $70 Billion in Capital (Update1)," *Business Week*, April 13, 2010, at *http://www.businessweek.com/news/2010-04-13/icbc-says-china-s-big-banks-need-70-billion-capital-update1-.html* (July 15, 2010); Xinhua, "China's Banking Assets Up 26% to 78.8 Trillion Yuan in 2009," January 16, 2010, at *http://news.xinhuanet.com/english/2010-01/16/content_12822155.htm* (July 15, 2010).

10. Hu Zhongbin, "Chinese Stock Market Looking Up After Government Intervention," *Economic Observer Online*, September 19, 2008, at *http://www.eeo.com.cn/ens/finance_investment/2008/09/19/114040.html* (July 15, 2010); "Central Hujin to Issue CNY 120 Bln Bonds in 2010-2011—Source," *The Wall Street Journal*, July 6, 2010, at *http://online.wsj.com/article/BT-CO-20100706-700050.html* (July 15, 2010).

with less state spending. More open investment and trade offer exactly that. While foreign attention is focused on the exchange rate and trade trends, China has finally moved a bit toward internationalizing the RMB. A trial program to use RMB in trade was greatly expanded. The trade program is quite substantial, but it can achieve little without a means of investing held RMB. Such a means is now under consideration.[11]

It is thus conceivable that the autumn meetings of the U.S.–China Joint Commission on Commerce and Trade could actually be fruitful. Longstanding American calls for balance of payments reform might be heeded. For its part, the U.S. should pledge an end to simultaneous application of countervailing and anti-dumping duties on Chinese goods or to make investment regulations more transparent.

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11. Dow Jones, "PBOC: To Gradually Expand Cross-Border Yuan Trade Settlement Trial," June 22, 2010, at *http://online.wsj.com/article/BT-CO-20100622-700257.html* (July 15, 2010); Reuters, "Update 1—China 'Mini-QFII" Could Launch This Year," July 1, 2010, at *http://www.reuters.com/article/idUSTOE66005020100701* (July 15, 2010).