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China's Economy Weakens: Implications for the U.S.

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China compiled its economic data for the first half of the year in less than two weeks. This is not nearly enough time to survey 1.36 billion people unless very powerful assumptions are made. The State Statistical Bureau (SSB) routinely makes very powerful assumptions.

According to the SSB, in 2010 the economy "showed good momentum of development." In the first quarter, it "maintained steady and fast growth." In the second quarter, it again "showed a good momentum of development." Since the Communist Party insists that the Chinese economy must always do well, the SSB merely provides details that require a few days to work out.

In fact, China's economy has been weakening. It is no surprise: Frantic spending in response to the global crisis brought gigantic amounts of waste and distorted resource allocation. This is being manifested in debt, price pressures, and slowing growth. The lessons for American policymakers are mixed: The People's Republic of China (PRC) is not 10 feet tall, but the U.S. must avoid similar errors.

The Official View. China's GDP was said to grow 9.6 percent on-year in the first six months, slowing slightly in the second quarter. On-quarter growth was given at 2.2 percent, but it is difficult to see how this number was calculated. Imports suggest industrial sluggishness. Crude oil imports climbed 7 percent in the first half, compared to 30 percent in the first half of 2010. Copper imports plunged 25 percent.[1]

Consumer prices ostensibly climbed 5.4 percent. The GDP deflator—using the arithmetic increase in GDP to measure inflation—was 8.7 percent. In the past 10 years, the GDP deflator has showed either larger or much larger amounts of inflation than official price indexes. Consumer inflation is generally understated because the index underweights housing. It was formerly complemented by a housing price index, but that was abandoned after it became obvious that results were being manufactured.[2]

The key to sustained Chinese growth is raising the level of personal consumption. On the positive side, household income grew better than 13 percent, and retail sales—the benchmark consumption measure—were said to climb nearly 17 percent. Unfortunately, consumption was again easily outpaced by fixed investment growth of over 25 percent even while investment is much larger. Though consumption is rising, the structure of the economy appears increasingly unbalanced. This imbalance is ultimately unsustainable and has warped the global economy.

The low quality of the PRC's statistics confuses matters. Reported income continuously grows

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Income, Saving, and Spending

Annual Percentage Change

	Disposable Income per Capita	Retail Sales	Personal Deposits
2002	11.2%	8.8%	17.8%
2003	7.8	9.1	19.2
2004	7.5	13.3	15.4
2005	8.8	12.9	18.0
2006	9.6	13.7	14.6
2007	11.5	16.8	6.8
2008	8.3	21.6	26.3
2009	9.4	15.5	19.7
2010	8.6	18.4	16.3
Average	**9.2%**	**14.5%**	**17.1%**

Source: National Bureau of Statistics of China, *China Monthly Statistics*, Beijing, Vol. 1 (2003)–Vol. 6 (2011).

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much more slowly than both spending and saving, which should be impossible. It is very likely that retail sales do not reflect true consumer spending. More encouraging, it is also likely that households are wealthier than officially portrayed.[3] If the latter is true, though, one implication may be that GDP "growth" is sometimes nothing more than the discovery of existing assets. Over time, the PRC has probably overstated its growth while understating the size of its economy.

The Li Keqiang View. Li Keqiang—currently designated as the next premier—has dismissed GDP as an economic indicator for China, preferring electricity production, rail freight, and bank lending.[4] Comparing these series is instructive. In difficult years, electricity production is slower than GDP, implying greater efficiency; yet in other years, it is faster, implying the opposite. Is the PRC temporarily able to become more energy-efficient but unable to retain those efficiency gains, or are there flaws in the data?

Rail freight is more striking, with little apparent connection to GDP. The gap between rail freight growth and GDP growth is never more than five points from 2002 to 2008. But in 2009, rail freight growth is 8.4 points lower than GDP growth. In 2010, the difference returns to barely one point. The trends do not match. In some years, GDP is accelerating and rail freight is decelerating. This is not credible: Either rail freight or GDP has not been accurately reported.

On loans, problems with the 2009 lending binge receive a great deal of attention. Local governments ran up huge debts as hurried projects yielded the typical low returns. The rush to lend curbed unemployment but also contributed heavily to over $2 trillion in nonperforming assets, perhaps 30 percent of GDP. Lack of disclosure prevents a precise accounting; local debt is a number that rises every time the government mentions it.[5]

1. Reuters, "RPT-Update 3-China's Copper Demand Stages Comeback in June," July 11, 2011, at *http://af.reuters.com/article/metalsNews/idAFL3E7IB05Q20110711* (July 11, 2011). All current figures are taken from National Bureau of Statistics of China, "National Economy Maintained Steady and Fast Growth," July 13, 2011, at *http://www.stats.gov.cn/english/newsandcomingevents/t20110713_402738885.htm* (July 13, 2011).
2. Aaron Back and Esther Fung, "China Scraps Property Data, Clouding View," *The Wall Street Journal*, February 17, 2011, at *http://online.wsj.com/article/SB10001424052748703373404576147792827651116.html* (July 11, 2011). All historical figures are taken from National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 1 (2001)–Vol. 6 (2011).
3. See, for example, Xiaolu Wang and Wing Thye Woo, "The Size and Distribution of Hidden Household Income in China," December 25, 2010, at *http://www.econ.ucdavis.edu/faculty/woo/9.Wang-Woo.Hidden%20Income%20in%20China.2010-12-25.pdf* (July 11, 2011).
4. Reuters, "China's GDP Is 'Man-Made,' Unreliable: Top Leader," December 6, 2010, at *http://www.reuters.com/article/idUSTRE6B527D20101206* (July 11, 2011); Derek Scissors, "China Grows 10 Percent Again: Is this Believable?" Heritage Foundation *WebMemo* No. 3098, January 20, 2011, at *http://www.heritage.org/Research/Reports/2011/01/China-Grows-10-Percent-Again-Is-This-Believable*.
5. Tom Orlik, "China Tallies Local Debt," *The Wall Street Journal*, June 28, 2011, at *http://online.wsj.com/article/SB10001424052702304447804576411013575221104.html?mod=googlenews_wsj* (July 11, 2011).

China GDP and Other Economic Indicators

Annual Percentage Change

	Revised GDP	Electricity Production	Rail Freight	Lending
2002	9.1%	11.7%	4.6%	17.2%
2003	10.0	15.4	6.5	20.8
2004	10.1	14.9	9.0	11.5
2005	10.4	13.3	8.2	9.8
2006	11.1	13.7	6.9	15.7
2007	13.0	14.9	8.6	15.8
2008	9.6	5.5	4.6	16.0
2009	9.2	7.0	0.8	31.7
2010	10.3*	13.3	9.2	19.9
2011**	9.6*	12.8*	7.8*	16.9
Average	**10.2%**	**12.2%**	**6.6%**	**17.5%**

* Estimate. GDP revisions to date have all been higher than first estimated. Most other figures shown in this table are not revised, so the numbers are incomparable.
** First six months.

Sources: National Bureau of Statistics of China, *China Monthly Statistics*, Beijing, Vol. 1 (2001)–Vol. 6 (2011); "National Economy Maintained Steady and Fast Growth," July 13, 2011, at *http://www.stats.gov.cn/english/newsandcomingevents/t20110713_402738885.htm* (July 13, 2011).

Table 2 • WM 3315 heritage.org

The understandable focus on local debt obscures broader concerns. Loan totals show economic deterioration. In 2007, the volume of formal bank lending was equivalent to 106 percent of GDP. In 2010, it was 120 percent. And this figure considerably understates the true quantity of lending due to the explosive growth in off-book lending by banks and other financial institutions starting in 2009.[6] Compared to 2004–2007, loans now must be much larger relative to nominal GDP to support the same speed of growth.

If the economy was on the brink in 2008–2009, hyper-aggressive lending made some sense. It is a greater concern that ensuing tightening is largely a fiction. Interest rate increases have lagged inflation, so real rates have slipped further into negative territory. Depending on the present level of off-book loans, lending is either average or high by historical standards on top of a now-huge base. Yet there is a belief in some quarters that current monetary conditions are too tight. All this put banks and other financials at substantial risk.

Implications for the U.S. Some American policymakers had acute China envy in 2009. The PRC was able to order banks to lend, providing short-term stimulus to a tottering economy; America was not. However, the inability to conduct such violent economic intervention has proven beneficial for the U.S.

American banks have been permitted to rebuild balance sheets to some extent, while Chinese banks were forced by the central government to destroy theirs. No matter one's view of crisis stimulus, a private-sector recovery is the desired outcome. Conditions in financial markets are now more conducive to such a recovery in the U.S. than in the PRC. This leaves Beijing reliant either on yet more harmful stimulus of its own or on gains in other economies.

The U.S. has a policy opening. For the first time in perhaps a decade, China's economic model may appear to be unappetizing. The PRC has to strain harder to reach the same speed of growth, and the burden is proving difficult to bear. American initiatives in promoting open markets, both bilaterally and multilaterally, will fall on more receptive ears than at any time since 2006. This presumes, of course, that the U.S. is willing to rely on markets at home.

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6. The People's Bank is adopting a broader measure, "social financing," to reflect this. Xinhua, "China to Better Regulate Total Social Financing," *China Daily*, February 18, 2011, at *http://www.chinadaily.com.cn/business/2011-02/18/content_12040485.htm* (July 11, 2011).