China's managed slowdown continues

15 September 2014

Following a batch of better economic data since the spring, fears of an imminent Chinese hard landing had largely disappeared from the headlines even up to a point where optimism about the economy's future was spreading again at the end of Q2. More recently, however, corrections in the property market and the fading of the measures announced earlier this year have started to weigh on economic sentiment. More evidence was provided by last month's slowdown in industrial production to 6.9% yoy (from 9%), the weakest figure since late 2008. Unsurprisingly, warnings about the fragile state of the Chinese economy are now coming back to the fore again. But just like we argued that the recent bout of optimism was exaggerated, we think the looming fears of a sharp slowdown will once again prove premature.

Most recent leading indicators reveal that economic sentiment is waning again. With exports and export orders picking up as the global economy slowly but steadily gathers pace, domestic forces are driving the latest decrease in sentiment. This is in line with the present correction in China's property market. Doomsayers claim that the long-awaited collapse of the Chinese economy is finally about to take place. The property crash, they argue, will weigh heavily on domestic demand as highly indebted households, firms and local governments are forced into a prolonged phase of deleveraging. Moreover, the resulting sharp rise in non-performing loans would then quickly erode the capital base of the banking system. That, in turn, would spur capital flight and have further disruptive effects on the broader economy. However, even though we have argued before that credit growth is far from sustainable, the chances that this scenario will play out in the near future are still very slim. First, economic data in the second quarter were somewhat better thanks to targeted fiscal and monetary measures. In fact, Chinese authorities have also managed to stimulate economic activity in 2012 and 2013 when hard landing fears first surfaced. Accordingly, we see little reason why authorities could not take additional targeted measures in case growth slips too quickly below the government's own target of 7.5%. An outright crash therefore is far from inevitable. Second, China's current account surplus, very limited external debt, state-owned financial sector and capital controls imply that capital flight can simply not occur en masse. Finally, although China has only made limited progress in rebalancing the economy away from investment towards consumption, authorities are very much aware of the necessity hereof. Premier Li's statements at the World Economic Forum last week once again highlighted the importance of structural reforms. Given the magnitude of the post-2008 credit boom, expectations of a rapid transition were never realistic in the first place. Instead, gradual progress has been made by installing a bold anti-corruption campaign, widening the currency's trading band and reforming public financing and social safety nets. More market-oriented reforms are expected to follow in the short and medium term.

The upshot is that economic growth is set resume the downward trend observed since the Chinese economy sharply recovered from the 2008-2009 crisis. There's little doubt that growth will continue to slow down from the current 7.5%. This may even happen faster than consensus estimates. The economy's dependence on credit and investment is still uncomfortably high. It is absolutely clear that more structural measures will need to be implemented in order to get economic growth on a more sustainable footing. However, dire warnings of an imminent sharp slowdown are likely to prove premature once again.