



The 2013 NPC and CPPCC Annual Sessions have ended with the formal selection of China's new leaders. Not surprisingly there were few surprises. My quick take is that the leadership is saying all the right things, but they have been saying these things for quite a while – nearly two years in the case of Li Keqiang, the new premier.

The constraints they face, however, have neither changed nor been addressed. First, any real rebalancing means much slow growth than Beijing seems willing to tolerate. Second, the groups ("vested interests") that have benefitted from the old growth model remain very powerful and very reluctant to allow any erosion of the benefits they have accrued.

Two weeks ago, in his last formal State of the Union speech as China's premier, Wen Jiabao announced that the 2013 growth target for China's economy was 7.5 percent. Here is the *Xinhua* article on the speech:

*A growth target of 7.5 percent and a greater focus on consumption and economic reforms were some of the goals set out by Premier Wen Jiabao in a keynote address on Tuesday. An inflation target of 3.5 percent was set, below the 4 percent target of 2012, Wen said in his last Government Work Report to the National People's Congress. The growth target is the same as last year's, when GDP increased by 7.8 percent from a year earlier, a 13-year low. Economic growth in 2011 was 9.3 percent and 10.4 percent in 2010.*

Until 2011 China's economic growth easily exceeded the target set by the government, but something strange happened this year. For the first time that I can remember, after issuing the target growth rate for the year, Premier Wen seemed to warn that the target would be difficult to attain. More specifically, he acknowledged that there was "growing conflict between downward pressure on economic growth and excess production capacity".

A few days later Zhang Ping, head of the NDRC, reiterated the concerns about overcapacity. According to *Xinhua*,

*Addressing surplus production capacity is a major part of efforts to adjust China's economic structure and transform its pattern of development, a senior economic official said Wednesday. Zhang Ping, head of the National Development and Reform Commission (NDRC), the top economic planner, said China as a manufacturing powerhouse has a serious overcapacity problem in some sectors.*

*The industrial sectors suffering most from overcapacity include steel, cement, electrolytic aluminium, plate glass and coal coke sectors, which are operating at 70 to 75 percent of their total capacity. Emerging sectors such as photovoltaic and wind turbine manufacturing have also shown excess capacity, with a 60-percent and 70-percent utilization rate, respectively, Zhang told a press conference held on the sidelines of the annual parliamentary session.*

*According to widely accepted international standards, normal market competition features 80 to 85-percent utilization of production capacity. "Under market economy conditions, a modest surplus production capacity can stimulate competition in the market and promote technical and management progress," said Zhang. But in China, steel and cement industries are facing great difficulties due to overcapacity, Zhang said, adding that half of the companies in the electrolytic aluminium sector suffered losses last year.*

China, in other words, is producing far more of everything than it can absorb or export, but the only way to keep growth high has been to invest even more, at least part of which creates even greater production capacity. This is what will make attaining the growth target difficult. The policy with which Beijing has been able to keep growth high for so many years has itself become a problem.

## DO YOU BELIEVE THE GDP NUMBERS?

We may have gotten a taste of what this means when we consider what happened in 2012. Last year China's official growth rate was 7.8%, above the 7.5% target but the lowest number in many years and far lower than the more than 10% growth rates China had generated for the past two decades. Much lower growth in 2012 suggested that rebalancing the Chinese economy, a goal that has been actively proclaimed since at least 2005 but which had never happened until 2012, was proving to be more difficult than expected.

But even with the lower growth numbers throughout the year economists were puzzled by evidence that the economy was in fact growing more slowly than the official numbers suggested. Energy consumption in China, for example, usually grows more quickly than GDP, but surprisingly, in 2012 energy usage grew by only 5.5%, well below the official growth rate of 7.8%. Other indicators also indicated that growth may have been lower than the official numbers suggested.

While some of the sell-side economists still insist that China's growth remained high and healthy enough, in fact among independent economists who specialize in the Chinese economy, both among Chinese and foreign economists there has been growing skepticism. A consensus is developing that China grew by less than 7.8% in 2012. For example Stephen Green at Standard Chartered, one of my favorites of the sell-side economists, refigured his numbers and guesses that instead of 9.3% for 2011 and 7.8% for 2012 (the official numbers), actual growth might have been 7.2% for 2011 and 5.5% for 2012. Other economists are suggesting even lower numbers, closer to zero.

I don't have my own estimates because it seems to me that all of these attempts to measure economic growth are actually measuring economic activity, which may itself overstate growth. If you spend \$100 million each on two separate bridges, one of which is actively used and the other rarely used, the official measures will have them contributing the same amount to GDP, even though the former creates real value and the latter does not. In either case if you then adjust the overall GDP numbers downwards by examining electricity usage, cement consumption, and so on, as the likes of Stephen Green do, you may end up with a more accurate estimate of economic activity, but you still treat the two bridges as contributing the same amount.

It isn't until you write down the debt associated with the second bridge that you end up with a more meaningful measure of GDP. Of course this makes the whole process very confusing and it is hard to compare different estimates. It isn't always clear how these estimates are reached, but as far as I can tell nearly all, if not all, of the downward revisions provided by various skeptical economists are still measures of economic

activity, and do not include estimates for debt write-down associated with unnecessary investment.

Still, these numbers do tell us something, and if we look closely at how growth was distributed in 2012 we might get a better sense of how hard it is to generate healthy economic activity. I think nearly everyone agrees that the first half of the year generated far slower growth, or economic activity, however measured, than the second half.

In the first half the authorities had managed to slow the growth in debt, which has been rising at alarming rates in the past decade and especially since 2009. Perhaps just as importantly, the rapid decline in inflation at the end of 2011 caused real interest rates to soar in late 2011 and early 2012. You can see this in the graph above, again provided by Stephen Green, and I will come back to this later in this issue of the newsletter.

As a quick aside, notice that the GDP deflator is pretty consistently roughly 2 percentage points or more above CPI inflation. I have always preferred the GDP deflator as a measure of inflation partly because I think it is harder to manipulate and partly because with consumption such a low share of GDP in China, even if the CPI numbers were accurate, which few of us believe, they are measuring too small a part of the economy to be terribly useful.

## **DEMAND IS DRIVEN BY BORROWING**

In a system in which almost all the growth is driven by increases in investment, and in which an increasing share of investment is being wasted on factories, bridges, real estate, airports, and other projects that have little or no economic value, rising debt can be a very worrying problem since the ability to service that debt is rising much more slowly than the debt. This is why Beijing has been so eager to slow the growth in debt.

But as they did so in the first half of 2011, growth seems to have dropped very sharply. By the middle of 2012 it seemed that growth had slowed so quickly, even if it did not fully show up in the official numbers, that Beijing may have gotten nervous and begun to allow credit to grow rapidly once again.

The result was a surge of growth in the second half of the year, a surge that has continued into 2013. But this growth came at a huge cost. Total debt in the system, especially in the unregulated parts of the financial system, has grown at a record-breaking pace. Here, for example, is Simon Rabinovich of the *Financial Times* on the subject:

Chinese credit issuance surged to a record high in January on the back of a boom in shadow banking, stoking concerns that the economy could overheat. Total new financing in January reached Rmb2.5tn (\$400bn) – up more than 50 per cent from December and more than double the figure a year ago – eclipsing even the start of 2009 when China unleashed stimulus spending to battle the global financial crisis.

*Analysts warned that the credit jump could lead to a sharp rise in Chinese inflation and debt levels if left unchecked and said that regulators would be forced to intervene to contain the excesses.*

*...The explosion in financing was only partly driven by banks, which made Rmb1.07tn in loans. The rest of the new credit – 60 per cent of the total – came from corporate bonds, loans by investment companies, direct lending from companies to other companies and bankers' acceptances, a popular form of short-term financing in China. These non-bank sources of lending, which are collectively referred to as shadow banking in China, are controversial. Regulators say they have good oversight of the situation, but ratings agencies have cautioned that the risks are mounting.*

*"Total financing is definitely quite high, surely a surprise to regulators," said Lu Ting, an economist with Bank of America Merrill Lynch. "Though this suggests that market demand for funding is quite strong and markets could be happy about this, regulators might be concerned about financial safety and inflation and may take some actions to control the growth."*

*The big increase in credit issuance stems from last year when China slouched to 7.8 per cent growth, its weakest in more than a decade. To revive the economy, the government stepped up the pace of infrastructure investment and gave a green light to banks to provide more funding, including through off-balance-sheet channels. This succeeded in fuelling a recovery in the final quarter of 2012 and the momentum of that upturn has continued through into the start of this year.*

It turns out that we've seen record growth in debt. Is it really a surprise then that the economy is still growing quickly?

This is what Premier Wen is referring to, I think, when he warns that achieving 7.5% growth in 2013 is not going to be easy. Last year was tough, and may have actually been worse than the numbers suggests, but more importantly any growth there was seems to have been driven by near exponential increases in debt in the second half of the year. If Beijing wants growth without soaring debt, what exactly are they going to do?

There isn't much they can do. And there are warnings coming fast and thick about debt. According to yet another article in *Xinhua*:

*Chief of China's banking regulator Shang Fulin has said his organization will take measures to prevent shadow banking risks from spreading to the banking system. As banks' burgeoning financial product businesses grow rapidly in China, it is inevitable that problems and risks will emerge, said Shang, chairman of the China Banking Regulatory Commission (CBRC), on the sidelines of the first session of the 12th National People's Congress, the country's parliament.*

*The CBRC, together with commercial banks, is considering strictly supervising the design, sale and capital flow of financial products, he said. Banks will be banned from selling products without authorization and selling private equity fund products. They will also be banned from misleading consumers to buy their financial products, according to Shang.*

It's good to know that misleading customers will be banned.

## **WE KNOW WHAT TO DO**

There have been so many articles in the Chinese and foreign press about problems in the banking system that I won't bother going through the topic much more except to note that Beijing cannot tolerate rapid credit growth and it cannot tolerate slow GDP growth. The problem is that it can only choose both or neither. There are no other options.

As credit concerns continue to rise, expect Beijing eventually to bite the bullet and stamp down on debt, in which case expect GDP growth rates to drop much, much more, in fact to well below anything we saw in 2012. The question is not whether this will happen, but when. Once Beijing is confident enough about its grip over vested interests and the consensus has developed within the leadership, growth rates will drop very sharply.

So this is probably why former Premier Wen is warning about the difficulty China faces in reforming the economy – a warning that he and Premier Li have made many times before but never more shrilly. Even newly-appointed President Xi seems worried. According to an article in the *People's Daily* he is calling out for the “courage” to deepen reforms:

*Communist Party of China (CPC) chief Xi Jinping on Tuesday called for courage like “wading through a dangerous shoal” to help deepen reforms in the country's development. While joining national legislators from China's economic hub of Shanghai to deliberate the government work report, Xi compared the difficulty facing the country's deepened reform and opening up to that in “storming a fortification.*

*The report was delivered Tuesday morning by Premier Wen Jiabao at the parliament's annual session. “We must have the courage like gnawing at a hard bone and wading through a dangerous shoal,” said Xi, who is general secretary of the CPC Central Committee.*

Meanwhile Premier Li warned about how difficult it was going to be to fight against the vested interests that are preventing reform. Here is an article from the *People's Daily*:

*“The reform is about curbing government power. As a self-imposed revolution, it will require real sacrifice and will be painful,” he said.*

Li went on to say, gloriously mixing metaphors, that reducing the role of the state “will even feel like cutting one's wrist.” He added:



*“Nowadays, stirring up vested interests is more difficult than stirring up one’s soul,” Li said. “But no matter how deep the water is, we must wade through because we don’t have other options – it’s our nation’s fate and future that are at stake.”*

Rebalancing has very difficult political implications, and these are the deep waters, I think, to which Xi is referring. More than ever I am convinced that if China is to rebalance its economy towards a more sustainable growth model – and rebalance it must if it is to avoid a financial crisis – its GDP growth rate will drop sharply with its average annual growth over the next decade unlikely to exceed 3-4%. My forecast is still an outlier, but over the past six months even the optimists no longer see it as unthinkable and more and more analysts are drawing their own projections closer to mine.

I have said often enough that we will be able to judge how resolute Beijing is and how capable of overcoming vested interests by how quickly credit growth is constrained and, with it, GDP growth. I expect to see high GDP growth (close to 8%) in the first half of the year but, if Beijing is able to move quickly, I expect growth to slow significantly in the second half.

If GDP growth does not slow, I will be worried about how long it takes the new leadership to get their arms around the problem that they clearly recognize (although perhaps still underestimate). The signals so far are good. Growth may be slowing even quicker than I had originally anticipated. Beijing and the various financial regulators are making strong noises about constraining credit growth.

Yesterday’s March flash PMI numbers, however, were strong. Here is *FT Alphaville*:

*The China flash manufacturing PMIs have beaten expectations this month, coming in at 51.7 compared to 50.4 in February, and above the forecast consensus of 50.8.*

The flash PMI numbers may have been better than expected but I am more impressed with the appointment of strong reformers (and worriers) in key positions among the various financial regulators, and I expect they will do whatever they can to keep credit from growing. As a possible sign, copper imports declined in February, although this may simply reflect huge copper inventories. In addition Mark Williams, of Capital Research, in his March 20 report, claims that “electricity output growth more than halved in y/y terms in January and February compared with December” which suggest weakness in heavy industry, and that the volume of freight being transported around the country has slowed very sharply.

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