How Weak Is China?

The Real Story Behind the Economic Indicators

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China’s economy is slowing. But is it still growing? China says yes, with an official growth rate of 6.9 percent in 2015 and a target of at least 6.5 percent for 2016. A CNN poll of industry economists yielded a consensus of 6.5 percent for 2016 as well, and the IMF is clinging to 6.3 percent. But many skeptics aren’t so sure. Barclays won’t go higher than six percent, Citi says five percent, and the ever-bearish Conference Board anticipates growth of only 3.7 percent in 2016, which is equal to its lowball estimate for 2015.

Indicators of real economic activity in China suggest that even 3.7 percent may be optimistic. Electricity, steel, and coal consumption all declined in 2015. Admittedly, there are special circumstances for each case. Electricity demand fluctuates depending on the weather. Steel is mostly used in construction, which is slumping as new apartments go unsold. Coal is used to generate electricity and to make steel. And as China navigates the transition from a manufacturing economy to a service economy, it needs less “stuff” to generate the same amount of economic activity.

But there are more bad numbers. The total tonnage of freight shipped by rail within the country fell by 4.7 percent in 2014 and 10.5 percent in 2015. December 2015 saw a 15 percent decline in tonnage from December 2014, a year-on-year decrease that has held steady for several months running. China’s exports likewise fell by 2.8 percent between 2014 and 2015. The purchasing managers’ index (PMI) has been stuck below 50 for ten straight months, indicating a long-term contraction in manufacturing activity. Meanwhile, the stock markets and currency exchanges have been in turmoil since the middle of 2015.

The only bright spot in China’s economy seems to be the Internet, but at 2.5 percent of the total economy, the online sector simply isn’t big enough to save the whole economy. Besides, online sales do little more than cannibalize local retail sales. Total (online and offline) retail sales growth in 2015 was a moderate 10.7 percent. Compare that with 18 percent in 2010. And a very good argument can be made that retail sales growth is actually much slower, perhaps less than two percent. In short, the numbers just don’t add up to an economy surging ahead at a (globally) impressive rate of higher than six percent.

In fact, the Chinese economy may not be growing at all. Lost in the shuffle of all these industry statistics is a crucial number from the tax office. China’s value added tax (VAT) revenues rose a meager 0.8 percent in 2015. In principle, VAT is a decent proxy for domestic economic activity, since it is by definition a tax on all of the value added in the economy—in other words, on new GDP. Only two major economic sectors are excluded from VAT: exports and government consumption. And China admits that its exports fell in 2015.

The implication is that the only thing keeping the Chinese economy afloat is government spending. As part of the world’s ultimate stimulus program, Beijing’s spending rose at an officially acknowledged rate of 15.8 percent in 2015, bringing the government’s official budget deficit up to 2.3 percent of GDP. Spending growth was even higher toward the end of 2015, reaching 36 percent year-on-year in October 2015. The total includes both central and local government spending, but
not off-budget items, spending by state-owned enterprises, or concessional loans made by state-owned banks. The smart money says that all those are rising too.

China’s State Council—the country’s chief administrative authority, which should be in a position to know—has stated that “experts believe” that China will run a fiscal deficit of “three percent or higher” in 2016. The Chinese Academy of Social Sciences says the 2016 deficit should be “three to four percent” of GDP. But if spending increases reach the high double digits while tax revenues decline into the low single digits, it doesn’t take a genius to figure out that trouble is brewing. As China’s economy continues to slow, China’s fiscal deficits are bound to increase.

Meanwhile, China has stuck to its official line that the economy will grow by 6.5 percent in 2016 and the government deficit will amount to three percent of GDP, meaning that nearly half of China’s 2016 economic growth will come from deficit spending. But indirect indicators such as electricity use, freight shipments, industrial output, merchandise exports, tax revenues, and even retail sales suggest that, in reality, China’s economy may grow at three percent or less. And the government’s true all-in deficit spending is without a doubt much more than three percent. The obvious conclusion is that the real economy in China probably isn’t growing at all. It may even be shrinking.

Growing or shrinking, it is almost certain that the only source of economic growth in China today is government deficit spending. How long the Chinese government can keep up the pace is anyone’s guess. The only sure answer is: not forever. In 2013 the Xi administration announced with great fanfare that henceforth the market would play a “decisive” role in China’s economy. It now seems likely that China’s flirtation with the decisive role of the market won’t last much more than two years. China’s market economy can survive a stock market crash. But it can’t survive a government fiscal meltdown.