The Rising Risk of a Hard Landing in China: The Two Engines of Global Growth—U.S. and China—are Stalling. UPDATED

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A comment by economist Brad Setser follows this article
An analysis by economist Eswar Prasad follows

For the last few years the global economy has been running on two engines, the U.S. on the consumption side and China on the production side, both lifting the entire global economy. The U.S. has been the consumer of first and last resort spending more than its income and running large current account deficits while China (and other emerging market economies) has been the producer of first and last resort, spending less than its income and running ever larger current account surpluses.

For the last few months the first engine of global growth has effectively shut down as the latest batch of macro news from the U.S. are worse than awful: collapsing consumption and consumer confidence, plunging housing, collapsing auto sales, plunging durable goods spending (while supply side indicators such as production, ISM (factory index) and employment are also free falling). The U.S. is entering its worst consumer recession in decades both supply and demand data look worse than in the severe recessions of 1974-75 and 1980-82. And in due time this tsunami of awful macro news, together with ugly downside surprises to earnings will take another toll on equity valuations that are now temporarily lifted by another bear market sucker's rally.

More worrisome there are now increasing signs that the other main engine of the global economy – China - is also stalling. Let us consider now in detail the evidence that China may be on its way to a hard landing…

The latest batch of macro data from China are mixed but all point towards a sharp deceleration of economic growth: official GDP data showing growth down to 9% from the 12% of a couple of years ago; sharply falling spending on consumer durables (autos); falling home sales and sharp fall in construction activity; leading indicators of the manufacturing sector (the Chinese Purchase Management Index (PMI)) showing a value of 44.6% (i.e. an outright contraction of manufacturing to a level below 50% indicates a contraction), its lowest level ever since its publication. 9 out of 11 PMI sub indices showed contraction - Output, New Orders, Input Prices, Purchases of Inputs, New Export Orders, Imports, Backlogs of Orders, Stocks of Major Inputs. Output index fell to 44.3 from 54.6 in September, while new orders dropped to 41.7 from 51.3, while the inventory index climbed to 51.4 from 50.5. The decline in total orders has been even stronger than in export orders, thus suggesting a weakening in both domestic and export demand. And the decline in construction activity is without doubt a major contributor to the recent weakness in industrial activity in China.

China's exports to the US as a motor of growth

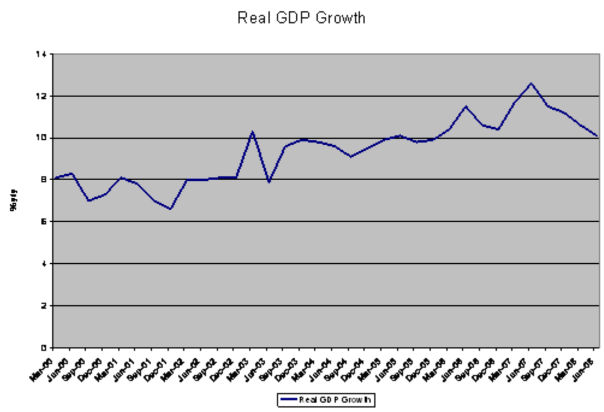
Note also that manufacturing, which accounts for 40% of China's GDP, is slowing based on surveys of manufacturers, matching with anecdotal reports of factory closures in China's southeast coast. Industrial production has slowed to the lowest level in 6 years (output rose 11.4% in September, from 12.8% in August). While slowdown may have been exacerbated by the Olympics shut-down, it has been on a slowing trend for months. The Federation of Hong Kong Industries predicts that 10% of an estimated 60 to 70 thousands Hong Kong-run factories in the Pearl River Delta will close this year. And of course the Chinese equity bubble (P/E ratios reached a ridiculous level of 60 plus late last year) has now gone bust big time with the Shanghai index having fallen over 60% from its bubbly peak.

There is thus now a growing risk of a hard landing in China. Let us be clear what we mean by hard landing. In a country with the potential growth of China, a hard landing would occur if the growth rate of the economy were to slow down to 5-6% as China needs a growth rate of 9-10% to absorb about 24 million folks joining the labor force every year; it needs a growth rate of 9-10% to move every year about 12-14 million poor rural farmers to the modern industrial/manufacturing urban sector. The whole social and political legitimacy of the regime of the ruling Communist party rests on continuing to deliver this high growth great transformation of the economy. Thus, a slowdown of growth from 12% to 5-6% would be the equivalent of a hard landing or a recession for China. And now a variety of macro indicators suggest that China is indeed headed towards a hard landing.

Note that China is an economy that is structurally dependent on exports: net exports (or the trade balance surplus) are close to 12% of GDP (up from 2% earlier in the decade) and exports represent about 40% of GDP. Real investment in China is about 45% of GDP and, leaving aside the part of this investment that is housing and infrastructure spending, about half of this capex spending goes towards the production of new capital goods that produces more exportable goods. So, with the sum of exports and investment representing about 80% of GDP, most of Chinese aggregate demand depends on its ability to sustain an export based economic growth.

The trouble, however, is that the main outlet of Chinese exports – the U.S. consumer – is now collapsing for the first time in two decades. Chinese exports to the U.S. were growing at an annualized rate of over 20% a year ago; while the most recent bilateral trade data from the U.S. show that this export growth has now fallen to 0%. But the worst is still to come in the next few quarters: after an ok second quarter in the U.S. (boosted by the tax rebates) U.S. retailers hoped that the consumer downturn would be minor: they thus placed over the summer massive orders for Chinese (and other imported) goods for Q3 and Q4. But now the U.S. holiday season clearly looks like the worst that the U.S. will experience in decades and the result of it will be a huge overhang of unsold Chinese goods. Thus, you can expect that orders of Chinese goods for Q1 of 2009 and the rest of 2009 will be sharply down dragging Chinese exports to the U.S. into sharply negative territory. And it is not just Chinese exports to the U.S.

Until a few months ago the U.S. was starting to contract but the rest of the advanced economies (Europe, Canada, Japan and Australia/New Zealand) were growing at a sustained rate, thus boosting Chinese exports. But there is strong evidence that a severe recession has now started in almost all of the advanced economies. You can thus expect that Chinese export growth to Europe, Canada, Japan, etc. will sharply decelerate in the next few quarters, thus adding to the fall in Chinese net exports. And once Chinese export growth sharply decelerates and net exports sharply fall you can expect a severe fall in capex spending in China as there is already a large excess capacity of exportable goods given the massive overinvestment of the last few years. Thus, a sharp fall in net exports and a sharp fall in real investment will likely trigger a hard landing in China. Considering the certainty of a recession in advanced economies and the high likelihood of a global recession, there is now a very high probability that Chinese growth could slow down to 7% or even lower in 2009 (7% growth for China is indeed now the forecast of a leading bank such as Standard Chartered); and 7% is just a notch above the 6% that would represent a near hard landing for China.



China's real growth rates, 2003-2008

Can aggressive monetary/credit and fiscal policy easing prevent this hard landing? Not necessarily. First note that China has already reduced interest rates three times in the last few months and easing some credit controls. But monetary and credit policy easing may be ineffective: if capex spending by the corporate sector will start to fall sharply as the fall in next exports leads to a sharp fall in the expected return on new capital spending on exportables a reduction of interest rates and/or an easing of credit controls will make little difference to such capex spending: easing money and credit will be like pushing on a string as the overinvestment of the last few years has led to a glut of capital goods. There is indeed already evidence that but corporate loan demands have diminished sharply while commercial banks have hesitated to lend while choosing to firewall risks. The government can ease money and credit but it cannot force corporations to spend and banks to lend if loan demand is falling because of low expected returns on investment.

Could fiscal policy rescue the day and prevent a Chinese hard landing? The optimists argue yes by pointing out that fiscal deficits and public debt are low in China and that China has the resources to engineer a rapid fiscal stimulus in a short period of time. But the ability of China to implement a rapid and massive fiscal stimulus is limited for a variety of reasons.

First, as pointed out by recent research (Global Insight) the combined effects of natural disasters, social strife in China's West, and the Olympics have created a large hole in the central government budget this fiscal year. The Ministry of Finance may have dipped into various stabilisation funds to avoid the appearance of running a large deficit. For regional and municipal governments, the decline in turnover in local property markets has reduced the flow of fees and taxes, causing them to delay ambitious industrial development plans in some cases.

Second, a hard landing in the economy and in investment would lead to a sharp increase in non-performing loans of the – still mostly public – state banks; the implicit liabilities from a serious banking problem would then add to the implicit and explicit budget deficits and public debt. Note that the poor quality of the underwriting by Chinese banks – that financed a huge overinvestment in the economy - has been hidden for the last few years by the high growth of the economy. Once net exports go bust and real investment sharply falls we will see a massive surge in non-performing loans that financed low return and marginal investment projects. The ensuing fiscal costs of cleaning up the banking system could be really high.

Third, as pointed out by Michael Pettis – a leading expert on the Chinese economy – a surge in tax revenues in the last 4 years has been more than matched by a surge in spending so that if revenue growth diminishes/reverses it might not be easy to slow spending growth proportionately. Contingent liabilities from non-performing loans could also reduce resources available for a fiscal stimulus. As argued by Pettis: Total direct and indirect debt (excluding long term obligations like unfunded pension liabilities) is probably much higher than the official numbers which, depending on how you count, range from 15% to 30% of GDP…However, for reasons I have discussed many times before, I think actual Chinese government debt exceeds the visible debt. My guess is that without counting the possibility of rising non-performing loans (NPLs) in case of an economic slowdown (which ultimately can become contingent liabilities of the government), total government debt in China is probably 50% of GDP or higher. That means that China has a lot less room for running large fiscal deficits than we might suppose, and during the time it most needs to run a deficit – when the economy is slowing sharply – we may anyway see a surge in contingent debt as bank NPLs surge.

Fourth, while a fiscal policy stimulus has already started, its scope and size has been so far relatively modest. Major stimulus measures announced by the Chinese government have included a major export tax rebate hike and a new state infrastructure plan and agreement to increase grain purchases to prop up export and investment growth. Further spending may include tax reform (value added tax to support fixed investment), more infrastructure spending, and on social security as well as government activities to provide capital to small and medium sized enterprises which can't access credit yet. The big question is, however, whether the Chinese government could increase the fiscal stimulus by an order of magnitude larger than the current effort if a quick order hard landing were to occur. The answer is probably not as moving a massive amount of economic resources from the tradeable sector to the non-tradeable sector (infrastructure and government spending on goods and services) will take time and cannot be done in a short period of time: the Chinese government has massive infrastructure projects for the next 5-10 years; but front-loading most of that multi-year spending over the next 12 to 18 months (if a hard landing risks occurs) will be close to mission impossible.

In conclusion the risk of a hard landing in China is sharply rising; a deceleration in the Chinese growth rate to 7% in 2009 - just a notch above a 6% hard landing – is highly likely and an even worse outcome cannot be ruled out at this point. The global economy is already headed towards a global recession as advanced economies are all in a recession and the U.S. contraction is now dramatically accelerating. The first engine of global growth – the U.S. on the consumption side – has now already shut down. The second engine of global growth – China on the production side – is also on its way to stalling. Thus, with the two main engines of global growth now in serious trouble a global hard landing is now almost a certainty. And a hard landing in China will have severe effects on growth in emerging market economies in Asia, Africa and Latin America as Chinese demand for raw materials and intermediate inputs has been a major source of economic growth for emerging markets and commodity exporters. The sharp recent fall in commodity prices and the near collapse of the Baltic Freight index are clear signals that Chinese and global demand for commodities and industrial inputs is sharply falling. Thus, global growth – at market prices – will be close to zero in Q3 of 2008, likely negative in Q4 of 2009 and well into negative territory in 2009. So brace yourself for an ugly and protracted global economic contraction in 2009.

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Brad Setser comments (http://www.nakedcapitalism.com/2008/11/brad-setser-begs-to-differ-with-nouriel.html) from the blog Naked Capitalism

Brad Setser and Nouriel Roubini have

collaborated in research and publishing on currencies but since have been working independently. Roubini issues a grim outlook for China ("Roubini Foresees Chinese Hard Landing"). A cornerstone of Roubini's analysis was that China was export-dependent and exports are falling fast:

> Note that China is an economy that is structurally dependent on exports: net exports (or the trade balance surplus) are close to 12% of GDP (up from 2% earlier in the decade) and exports represent about 40% of GDP. Real investment in China is about 45% of GDP and, leaving aside the part of this investment that is housing and infrastructure spending, about half of this capex spending goes towards the production of new capital goods that produces more exportable goods. So, with the sum of exports and investment representing about 80% of GDP, most of Chinese aggregate demand depends on its ability to sustain an export based economic growth.
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> The trouble –however – is that the main outlet of Chinese exports – the U.S. consumer – is now collapsing for the first time in two decades.

Setser characteristically is more measured, and (while not naming Roubini) takes issue with the notion that China is as beholden to exports as Roubini maintains (note he clearly regards net rather than gross exports as the relevant metric):

There has long been a rather sterile – at least in my view - debate over how much exports contributed to China's recent growth. It has long been clear that:

a) Most of China's growth didn't come from exports. It couldn't. Net exports almost never generate 10% growth on their own.

b) The absolute size of the contribution of net exports to China's growth was large. In 2005, 2006 and 2007 net exports added between 2 and 3 percentage points to China's growth. When net exports added close to 3 percentage points to the United States growth in the second quarter, no one argued that the contribution to US growth from net exports was small.

....The World Bank expects that net exports will contribute around one and a half (1.5) percentage points to China's growth. Real export growth topped real import growth – though both slowed. 1.5% percentage points from net exports isn't bad. It is more than the US had gotten on average over the last seven quarters. Indeed, it is not all that different from the average contribution net exports have made to US growth in 2008.

The Chinese exporters who were doing well just weren't as vocal as the textile and toy producers who weren't. They also tend to be more capital-intensive and thus employ fewer people.

And despite all the (true) talk about the difficulties some Chinese exporters now face, net exports almost certainly contributed positive to China's growth in the third quarter. Real export growth in the third quarter (on a y/y basis) still exceeded real import growth. That is why China's nominal trade surplus was basically flat during the first three quarters of 2008 even though China was paying way more for its commodity imports.

The sharp contraction in US consumption, the rise in the yuan v the euro, Europe's own slowdown and the latest data from China suggests that real Chinese exports could soon fall. If net exports are contributing to growth, it will be from a fall in imports, not a rise in exports. That is sure to slow China's growth.

Absent the close to 3% contribution from net exports in the boom years, China's growth would have been a (respectable) 9% rather than above 11%. With a negative 3% contribution to growth during the boom (as is often the case), growth would have been close to 6%. And if net exports turn negative now China's growth clearly would slow sharply.

But the real key to forecasting China's future growth consequently is determining whether domestic consumption and above all investment will continue to grow strongly in the absence of strong export demand. Remember, over the past few years both domestic investment and exports increased rapidly. If they fall together as well, Chinese growth will slow quite significantly.

And unfortunately the latest indicators seem to suggest that they are correlated; consequently domestic demand may fall along with exports.

That isn't good for anyone.

The (likely) fall in construction is particularly worrisome. China's new capital intensive export sectors haven't been huge job generators. Building buildings by contrast employs lots of people – including a lot of migrants from rural areas.

Chinese policy makers recognize that China's economy is slowing. They are trying to stimulate the economy in a host of ways. Loan limits have been lifted (and amusingly, their presence was only formally acknowledged when they were lifted). New infrastructure projects have been announced. Useful (though tardy) steps are being taken to improve China's social safety net. It just isn't clear if they will be powerful enough to offset a smaller contribution from net exports and a (likely) slowdown in investment.

I should note that China is also taking steps to promote exports, notably by increasing its export rebates. That is far less helpful to the global economy.

If the signs from China continue to point to a sharp slowdown, all the large parts of the global economy may enter into a slump at the same time. That isn't good.

A final point: it is often argued that China needs rapid growth in order to generate jobs, and consequently 6-8% growth doesn't cut it. That is only partially true. A lot depends on the composition of growth. Recent Chinese growth has been capital not job intensive, so very rapid growth hasn't translated into rapid job growth. If China shifted the basis of its growth, it might be able to generate more jobs even if the overall pace of growth changes. The risk though is that China won't change the basis of its growth – so slower growth will mean fewer jobs. But we shouldn't lose sight of the fact that it is unusual for a country growing at 5-6% not to be able to generate strong job growth.

For a further analysis of China's attempt to spur exports, see Setser's post (http://blogs.cfr.org/setser/2008/11/10/does-a-bigger-boom-imply-a-bigger-bust/)of November 10, 2008.

The Effect of the Crisis on the U.S.-China Economic Relationship (http://japanfocus.org/data/prasad.us-chieconreln.pdf)

An analysis by Eswar Prasad