

Misreading China's Economy

Why the Old Measures of Growth Don't Work

By Edoardo Campanella

January's global stock market rout was initially triggered by mounting concerns over China's shrinking industrial sector. But such concerns are unjustified. By now, it is clear that Beijing is doing everything in its power to rebalance its economy from industrial to service-based. In 2013, services overtook the industrial sector in both total size and pace of growth, and they now account for almost 50 percent of China's GDP. Yet the analytical tools that we use to assess China's performance haven't caught up with the structural changes now under way, which means that observers can easily get China wrong.

At the moment, markets track the performance of the Chinese economy by focusing on indicators that apply, for the most part, to the old economy and pretty much ignore developments in services. Every month analysts closely monitor data on China's exports, consumption of raw materials, and industrial production. They also scrutinize the moves of Chinese authorities, such as the adoption of expansionary monetary policies, to understand whether they are meant to support struggling manufacturers. At the beginning of January, for example, analysts used a string of disappointing figures from the industrial sector, coupled with an ill-timed depreciation of the yuan against the U.S. dollar by the People's Bank of China, to confirm the direst predictions of an imminent economic crash. But China's economy is, in fact, far from collapse and growing at an official estimate of 6.9 percent.

Moreover, given the opacity of China's official GDP statistics, one of the most widely used GDP trackers for the Chinese economy is the so-called Li Keqiang Index, which combines data about credit growth, energy consumption, and freight transport volumes—all indicators that are more sensitive to shocks in the industrial and commodity sectors than to changes in aggregate economic activity. The rationale of the indicator reflects the way the old economy functions: factories, cheaply funded by state-controlled banks, produce goods by massively consuming electricity, and they ship them by train to the closest ports, where they are subsequently sent abroad. The different versions of this measure point to GDP growth for 2015 ranging from 2.9 to five percent, well below the official estimate of 6.9 percent.



Aly Song / Reuters, Security guards stand in front of the soon to be opened largest Louis Vuitton store in China in Shanghai, July 18, 2012.

The Li Keqiang Index approach is crude, but it was acceptable a decade ago when the industrial sector represented more than 60 percent of China's economic activity when measured as gross value added (or production minus capital). Now, however, this GDP proxy misses most of the economic picture. As a concrete example, consider the role of two indicators:

the monthly growth in train cargo and in train passengers. Cargo growth serves as a proxy for the performance of the old industry-based economy. It is used in the Li Keqiang Index. Passenger growth is a proxy of domestic tourism, a sector that is expected to expand as more and more people reach the middle class. It is not included in the Li Keqiang Index.

Freight traffic has contracted for several quarters, and it is now shrinking by 15 percent on an annual basis.

This indicates a softening in industrial growth that has indeed slowed from 15 percent in the first quarter of 2010 to the current 6.1 percent, at least according to the official numbers provided by Beijing. But since mid-2012 passenger traffic has continued to grow at around 10 percent annually. Of course, this measure might also include commuters or rural to urban migration. Still, the growth in passenger traffic remains consistent with domestic tourism activities, which also expands by about 10 percent annually, contributing to about four percent of China's GDP. Since these two measures send opposite signals, including in the GDP tracker, using one over the other dramatically changes the overall picture of the economy.

A DECOUPLING ECONOMY

A closer look at China's service sector reveals a more reassuring picture of the country's economic performance. From January to November of last year, China registered 3.9 million new companies, mostly concentrated in tourism, health care, sports, and education. In addition, wages, growing at more than ten percent annually, have empowered Chinese households in an unprecedented way, giving rise to more consumption. In 2014, China was the second-largest market in the world for the film industry, with box office revenues at more than \$4 billion. Its digital economy is also picking up; online banking, mobile travel booking, and on-line payments are expanding at double-digit rates. Although private consumption is still low at just 34 percent of GDP, discretionary spending on recreational or cultural activities is growing at more than 7 percent annually, a much faster rate than on basic goods such as food. As the McKinsey Global Institute noted in a report, "You just don't get a consumer growth story this good anywhere else."

Revised versions of the Li Keqiang Index, which include indicators for the service industry, are broadly consistent with the official GDP figures provided by China's government. The Conference Board, an economic and business research organization, for instance, has recently started to track China's economic performance by combining statistics from a broad range of sectors, including electricity, passenger transport, industrial production, retail sales of consumer goods, and manufacturing employment. This GDP proxy predicts six to 6.5 percent growth in 2016, broadly in line with Beijing's numbers. Also, China's State Council, the nation's cabinet, attempted to divert the market's attention last November to its new economy by introducing the New Li Keqiang Index, which includes three variables: employment, residents' income, and a measure of environmental improvement. But this undoubtedly came across as propaganda to distract from contraction in the industrial sector.



Reuters, A customer shops for shoes at a mall in Hefei, Anhui province, March 10, 2015.

Although a hard landing by China's industrial sector might result in enormous costs for the rest of the world, especially for machinery exporters, the emergence of a thriving middle class in China may partly offset the negative spillover effects by opening up one of the largest markets for consumer goods to the rest of the world. Even if the industrial sector drops to 3.5 percent annual growth (and this would constitute a hard landing), and assuming that the services industry expanded at

around 8.8 percent (which is in line with its projected long-term trend), the Chinese economy would still grow at around six percent. This may be less than the astonishing growth that the world has gotten used to, but it is certainly not a crash.

OUR INTELLECTUAL SLUGGISHNESS

China is a tale of two economies: one old, one emerging. Markets and analysts, like Danny Gabay at Fathom Consulting and Russ Mould at AJ Bell, tend to focus mostly on the old one. Behavioral economics explains

this phenomenon as a tendency of human beings to make systematic errors in judgment due to a sort of inertia in our thinking—we like to believe that the world will always be as it has always been. Even when we acknowledge that some major transformation is taking place, we are slow to update our analytical toolbox to properly assess the new reality. This is a dangerous habit.

Collectively, this errant mode of thinking, or rather, reacting, might lead to disastrous events, such as panic selling, which could cause a market crash. This mistake is reinforced by the kind of data we collect on China. Most of the indicators used to gauge the health of the service industry are released with considerable time lags. For instance, data for online services are six months late, which make it impossible for investors to predict turning points in China's business cycle. Timelier statistics, such as retail sales, exclude data from the online service economy. Economists, then, are left with an incomplete picture of Chinese consumers and fund managers are forced to rely on high frequency indicators related to the old economy in order to make their investment decisions, running the risk of misreading the economic reality. Last January, for example, a disappointing China Caixin Manufacturing PMI, which measures the temperature of the manufacturing sector and is supposed to signal the overall health of the economy, was enough to confirm fears of a hard landing and send shock waves through the global financial system.

To get a sense of what is really happening in the Chinese economy, analysts should use unorthodox indicators that are not part of a standard macroeconomic toolbox—for instance, box office revenues or the rise in users of 4G mobile technology. Building new models, gathering new indicators, and creatively combining knowledge from apparently unrelated fields is necessary if observers are to cope with the new economy, identify the sources of change, and foresee how disruptive forces will interact in the future. At the same time, it is in Beijing's own interest to cooperate with international organizations like the International Monetary Fund, the World Bank, and the Asian Development Bank to construct more transparent and comprehensive statistics that investors can truly trust, thus preventing unjustified panic and financial turmoil. January's financial storm should serve as a warning to everyone to begin this process sooner rather than later.