American Enterprise Institute for Public Policy Research

Economic Outlook

April 2012

Is China Slowing Down?

By John H. Makin

With problems in the manufacturing, housing, and export sectors in China, we will likely see slower gross domestic product growth for the world's second largest economy in 2012. China's leadership is changing for the first time in a decade, and its new leaders have suggested that significant shifts in economic and currency policy are unlikely to occur during the transition. However, should China's leadership remain content with slower growth, the global economy will suffer. If China's growth loses momentum in 2012 and is coupled with similar losses in the United States and Europe, the recovery disappointment could well exceed that which appeared in 2010 and 2011. Despite these challenges, China has a unique opportunity to demonstrate its maturity as a player in the global economy. Through stimulus measures to its own economy, China could push for a bigger global economic pie rather than increase its share of a shrinking pie and in the process influence global economic growth in 2012.

China's economy is slowing down, from a reported 9.2 percent annual rate of growth at the end of last year to approximately 7 percent during the first quarter of this year. Whether China's growth will reaccelerate later this year depends on the global growth driving Chinese exports and on Chinese government policies—especially credit policies impacting China's housing market and fiscal measures aimed at spending on infrastructure.

The tangible signs of slowing Chinese growth include a March drop in a manufacturing index that accurately tracks overall gross domestic product (GDP) growth. The March purchasing manager's index (PMI) estimate from HSBC Holdings was reported at 48.3 in late March, a four-month low that is down substantially from last year's level of 52. Interestingly, in contrast to the HSBC index, the official Chinese March PMI index (which was reported at the same time as HSBC's) rose sharply to 53.1. Most analysts attributed the rise in the official index to seasonal factors that will subsequently be reversed. The fact that most Chinese stocks were down

Key points in this *Outlook*:

- Slumping Chinese manufacturing, housing, and exports suggest slower GDP growth in 2012, and shifts in policy that would reverse this trend are unlikely to occur during China's leadership transition.
- In the midst of European economic austerity and looming US tax hikes, China's slowdown could not come at a worse time.
- By stimulating its economy, China could promote a worldwide economic recovery this year—but whether the country will contribute to global growth or act in self-interest via currency manipulation remains to be seen.

John H. Makin (jmakin@aei.org) is a resident scholar at AEI.

slightly after HSBC's PMI index was announced suggests that the official PMI figure is not being taken at face value.

While manufacturing is slowing, China is also experiencing a housing slump. During February, housing prices in China declined in forty-five of seventy cities surveyed by the National Bureau of Statistics, continuing a trend underway over the past six months. As its economy has slowed, China's inflation rate has dropped to about 4 percent from last year's peak of almost 8 percent. China's slowing internal growth has been accompanied by a sharp drop in exports.

Perhaps not by coincidence, the steady (about 4 percent) trend appreciation of China's renminbi (RMB) currency appears to have ended since the start of 2012. An end to RMB appreciation makes economic sense from China's point of view, because less currency strength makes China's exports less expensive in global markets where growth is slowing. Less currency appreciation also helps China avoid shrinking its share of the smaller global export market. Furthermore, the drop in China's inflation rate has lessened the need to allow currency strength (lower prices of imported goods) to blunt inflation pressures.

A Change in Currency Policy?

There are also internal political reasons for China to lean toward a trendless currency during 2012. This fall, China's leadership will change for the first time in a decade as President Hu Jintao and Premier Wen Jiabao hand over power to their successors. During such transitions, China's ruling class prefers to avoid abrupt economic changes, especially those tied to currency policy with high external visibility. After the March National People's Congress, Premier Wen declared that the "RMB exchange rate is probably close to an equilibrium level."[1]

The premier's atypically direct statement about the currency underscores the likelihood that the transitional period since 2005—during which the currency's value has risen substantially—is over. Wen's declaration that the RMB has reached an "equilibrium" level after substantial appreciation conveys that China's new leaders may prefer to wait to address the issue of further exchange rate adjustment until after they assume power this November. Going forward, movements in the RMB may be both stronger and weaker, centering on a new equilibrium level.

It is important to recognize that the possibility of two-way exchange rate flexibility also gives China's ruling Politburo another lever with which to manage the nation's economy. Should slower growth persist along with falling inflation, a weaker Chinese currency could help stabilize growth and inflation. As China's economy matures, leaving behind its era of persistently high growth, its leaders are beginning to think of ways to manage the transition. More exchange-rate flexibility can help China's economy, notwithstanding the conflicts about currency manipulation a weaker RMB may engender with China's trading partners, especially the United States.

More exchange-rate flexibility can help China's economy, notwithstanding the conflicts about currency manipulation a weaker RMB may engender with China's trading partners, especially the United States.

An International Role for the RMB?

China is sending additional currency policy signals consistent with the expectation of somewhat slower economic growth, coupled in turn with the further internationalization of its currency. Internationalization of the RMB would underscore China's role as a maturing modern economy. China's efforts to consolidate its newfound prominence include measures to shore up its financial sector to bring it into better alignment with the country's status as the world's second largest producer of goods and services. So far in 2012, China Development Bank has offered a large increase in new RMB loans to Asian countries, to the emerging economies of Brazil, Russia, and India, and even to some indebted European countries. Extending RMB loans to more countries encourages the internationalization and growth of China's still-nascent financial sector in a number of ways.

If, for example, an Italian, Russian, or Indian firm obtains RMB loans, then paying the interest on such loans (not to mention repaying them) is less risky if the borrower receives Chinese currency for the goods it sells globally. RMB borrowers outside China have an extra incentive to invoice their export customers in RMB;

this helps them obtain the necessary currency to pay interest and amortization on their loans without incurring the risk of exchange rate changes that might increase the cost of such borrowing in their own currency.

Slower Chinese Growth Increases Global Risks

We can also look at the Chinese growth question in a broader context. The likelihood of a Chinese growth slowdown during 2012 presents, along with Europe's austerity-induced recession, a headwind that may more than offset the global boost caused by the modest pickup in US economic growth. US growth accelerated to a 3 percent annual rate in the fourth quarter of 2011, up from a more tepid rate of 1.8 percent during the third quarter. Most estimates for US growth during the first half of 2012 are for a more modest 2 percent rate, with the still-tepid pace relying heavily on what may be temporary wealth gains tied to higher equity prices.

The modest rise in early 2012 US growth is also associated with the extra tax cuts passed by the US Congress late in 2011, amounting to about $160 billion. These tax cuts represented an extension and expansion of the extra tax cuts passed in late 2010. The US Federal Reserve has also attempted to keep interest rates very low with extra purchases of long-term treasuries and further promises of zero short-term interest rates until well into 2014.

> The likelihood of a Chinese growth slowdown during 2012 presents, along with Europe's austerity-induced recession, a headwind that may more than offset the global boost caused by the modest pickup in US economic growth.

As Europe's economy has suffered from the fallout of the European debt crisis, the European Central Bank (ECB) has further expanded its easing since December with nearly €1 trillion of additional three-year loans at guaranteed low interest rates to European banks. The ECB's aggressive monetary ease under its new president, Mario Draghi, aims to help European banks repair their balance sheets in the face of uncertainty about the value of making substantial loans to shaky European governments. This step—along with the February and March "containment" of the acute Greek debt crisis—has helped calm financial markets during the first quarter of 2012.

Adding to the accommodations offered by central banks worldwide, the Bank of Japan chimed in on Valentine's Day this year with more asset purchases equal to about 2 percent of GDP coupled with a pledge to end Japan's persistent deflation by targeting 1 percent of actual inflation. The resulting effect has been modest so far with some increase in the stock market and some moderation of the yen's appreciation.

A striking conclusion about China's economic growth outlook emerges from this brief overview of the global economy for 2012: it is not a good time for China's growth to slow down. While US growth was stronger at the end of 2011, the rest of 2012 promises slower growth. The US outlook will become even more problematic at the end of 2012 when already-legislated tax increases and spending cuts take hold. These measures will subtract about four percentage points from early 2013 growth. The measures will need to be considered by a lame-duck Congress after the November 2012 presidential election if any changes are to be made.

Changes in fiscal policy such as not ending tax cuts and not reducing spending from levels specified under current law will add sharply to already large deficits. The American dilemma thus becomes the price of kick-the-can budget policies whereby deficit reduction is postponed and one-more-time tax cuts and spending programs are continued. The fiscal stimulus measures employed since 2009 are meant to provide a temporary boost to growth, yet they will be followed by a growth drag once they are removed. The longer such one-off measures are extended, the larger the fiscal drag will be once they are removed. Hence we will see a prospective large fiscal drag, which will emerge at the end of 2012 under current law when a broad range of tax cuts and some spending measures are removed all at once.

A Leadership Opportunity for China

The questionable outlook for US growth toward the end of 2012—coupled with Europe's recession and weakness in emerging markets—makes the focus on China's perspective growth rate over the coming year even more compelling, especially when it comes to determining whether 2012 will witness the same growth disappointments that arose in 2010 and 2011. The supportive policy response in developed markets—more monetary and fiscal stimulus in the United States both in 2010 and 2011 and more monetary stimulus in Europe in 2011—will likely not be repeated. If China's growth loses momentum during 2012 alongside similar momentum losses in the US and Europe, the recovery disappointment in 2012 could well exceed that which occurred in 2010 and 2011.

What with inflation having dropped well below the 4 percent target set by China's policymakers and the fiscal deficit having dropped below 2 percent of GDP, China could manage further stimulus. Policymakers should consider additional spending on transportation and rural infrastructure, especially in view of the weakening impact of China's external sector growth, and tied to the weak growth outlook in the global economy. Whether the desire for no new policy initiatives during China's current transition to new leadership will prevent new economic stimulus remains to be seen.

China's new leaders could break with tradition and signal their new outlook on China's role in the global economy by stepping in to boost growth at a time when the global economy needs help. This kind of initiative would represent an effective way to enhance China's image as a leading mature economy. Better to push for a bigger global economic pie with extra stimulus than to push for a bigger share of a static or shrinking pie with more currency intervention to keep the RMB undervalued.

Note

1. JP Morgan, *JP Morgan Global Data Watch* (e-mail, March 23, 2012).