CHINA: ITS GREAT GROWTH STORY GROWS OLD
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"He who gives no thought to difficulties in the future is sure to be beset by worries much closer at hand." Confucius, "The Analects" (Book XV, 12)

CONCLUSION

Much of the world currently displays nearly unblinking faith in the expertise of key central bank guardians such as the Federal Reserve Board, European Central Bank, Bank of Japan, and Bank of England. These illuminated central bankers supposedly will continue to play substantial and successful roles in engineering further economic growth via easy money schemes such as interest rate yield repression, quantitative easing (even if money printing ends in America or elsewhere, the securities buying operation may not be unwound quickly, if at all), and forward guidance wordplay. The Fed wizard in particular also surely has an almost pain-free and coherent exit strategy from its longstanding highly accommodative programs, right?

Ongoing trust in such marvelous central bank talent finds a counterpart in widespread belief that the Chinese economic growth miracle will continue for the long run, or at least the foreseeable future. Significant government deficit spending and relaxed credit policies indeed sparked much Chinese growth in recent years. However, Chinese real GDP growth probably has slowed more than many believe. Assorted intertwined variables hint at this reduced expansion and suggest that the slowdown in its growth rate probably will continue over the medium term. Given China's crucial role in the interdependent global economy, this relative weakness in its GDP growth should have ominous implications for growth elsewhere.

CHINESE GROWTH: TIME FOR A NEW STORY

After its amazing real GDP growth summit of 14.2pc in 2007, despite the end of the Goldilocks Era and the eruption of the worldwide economic disaster, Chinese real GDP growth slipped merely to 9.2pc in 2009. Real GDP soared a remarkable 10.4 percent in 2010 and advanced a robust 9.3pc in 2011. However, expansion cooled to 7.7pc in both 2012 and 2013. See the International Monetary Fund's "World Economic Outlook" ("WEO"; April 2014, Table 1.1; Statistical Appendix, Table A4).

However, China's enviable output growth apparently will slow further. Not only does the IMF predict China's 2014 real GDP will dip to 7.5pc, with 2015 at 7.3p (moreover, way out in 2019, growth subsides to 6.5pc). Read the fine print of the IMF's recent Article IV Consultation with China (6/5/14). The IMF repeats the mantra of around 7.5pc Chinese growth for 2014 as well. However, keep in mind China's economic reform rhetoric (as in the November 2013 Third Plenum agenda). If implemented significantly, financial discipline probably would erode GDP expansion substantially. The IMF wants China to perform a balancing act, to shift to a sustainable growth path as it confronts its reform challenges (risks). Thus, and arguably to prepare audiences for a greater deceleration than its own WEO predictions suggest, the IMF believes China should target 2015 growth at around seven pc "with a somewhat lower bound". This lower bound language, though the IMF does not attach numbers to it, arguably means that growth of around 6.5pc or so would be tolerable. The IMF underlines it does not want "too sharp a decline of growth".

China reported 7.4pc 1Q14 growth versus the prior year quarter. However, economists claim the 1Q14 annualized rate compared to 4Q13's "appears to be well under 7 percent" (NYTimes, 4/16/14. pB4).

As always, Chinese GDP trends will intertwine with those elsewhere. Will US and European economic growth accelerate? To what extent will the Federal Reserve's gradual cutback (tapering) of its money printing extravaganza influence US and thereby global GDP trends?

Chinese industrial (value-added) production rates seem to be edging downward, In April 2014, it expanded 8.7pc year-on-year. Compare that of April 2013's 9.3pc and December 2013's 9.7pc year-on-year jumps. Chinese electricity production gains have slowed in recent months. Calendar 2013 electricity output marched up 7.6pc year-on-year. January/February 2014 output grew 5.5pc year-on-year, with March up 6.2pc and April rising 4.4pc.

International financial history hints that massive percentage economic growth rates are not likely to persist once significant industrialization has persisted for many years. Given China's rapid development in recent years, how likely is it that it can sustain the substantial growth of this glorious golden era? Moreover, China's gigantic GDP gains relied on deficit spending and easy credit (growing leverage) to a significant extent. Consequently, reduced deficits and tighter credit probably will slow growth rates.

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The nation needs strong economic growth to reduce social tension. If China's economy was booming in recent months, and is likely to remain strong looking forward, why has the country's political leaders engaged in such noisy campaigns against official corruption?

Note also China's recent island disputes with Japan, Vietnam, and the Philippines. Admittedly issues of long run political power plays (relationships) and natural resources lurk in these disputes. But if all is fine on China's home front, why does it engage in such significant headline-making quarrels?

TAKING CREDIT: CHINESE DEBT TRENDS

"You need more than luck in Shanghai" declares Mrs. Bannister in the film "The Lady from Shanghai" (Orson Welles, director)

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Admittedly, China's official and private sector debt scene is murky. Yet the edging down of its real GDP growth is occurring in an environment of its increasingly troubling debt and credit situation. All else equal, efforts to solve or at least mitigate debt and credit problems probably will result in greater than expected (desired) cuts in the country's economic growth rate.

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On the surface, China's government debt situation looks rather good, especially in comparison with America's, Japan's, and much of Europe. See the IMF's "Fiscal Monitor" (April 2014, Statistical Table 5) for China's general government overall balance as a percent of GDP. Its recent budget deficit top was -3.1 percent in 2009, averaging about -1.7pc over the 2010-2013 span. The IMF forecasts the country will run a -2.0 percent deficit in 2014, -1.6pc in 2015; in 2019, the deficit will be merely -.6pc. Chinese general government gross debt peaked at 33.5pc of GDP in 2010 (17.0pc in 2008). It subsequently tumbled as a percent of GDP, reaching 26.1pc in

2012 and 22.4pc in 2013. The Fiscal Monitor predicts 20.2pc in 2014 and 18.7pc in 2015, with 2019 at 14.4pc (Statistical Table 8).

Yet the nation's government debt situation is not as rosy as it seems. The main Fiscal Monitor table tells only an incomplete tale in regard to China. One must first look at a footnote in the table. This fine print mentions the IMF's 2013 Article IV Staff Report. That Article IV Report underlined that "augmented debt", which includes local government financing vehicles and other off-budget activity, was about 46.2pc of GDP at end 2012. This 46.2pc figure is about 20 percent above the Fiscal Monitor's 2012's tabular estimate of 26.1pc. Observers therefore should add that amount as to adjust general government debt depicted in Statistical Table 8 for subsequent years such as 2013 (it is thus around 42.4pc), 2014, and 2015.

However, the "augmented debt" percentage relative to GDP as of end 2013 may be even higher than the footnote implies. Referring to a December 2013 Chinese government audit, the Financial Times states that borrowing by the more than ten thousand local government finance vehicles (the FT does not speak of other off-budget activity) had reached about $2.5 trillion, or 32 percent of GDP (5/22/14, p6). So 32 percent plus 22.4pc general government debt for end 2013 gives augmented debt of 54.4pc. Even if the central government debt picture has improved since around 2010, the local government situation apparently has not.

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What's going on elsewhere in the debt scene? Shadow banking plays an important role in financing within China's economy. Are some shadow banking interest rates rising due to weaker creditworthiness? Some have expressed concern regarding overheating real estate marketplace sectors. China supposedly is cracking down on credit supply. According to the Financial Times (4/16/14, p1), "total social financing" (a measure of liquidity in the economy) fell nine pc year-on-year in the first quarter of 2014. "Bad loan writedowns at Chinese [five biggest] banks soar" (Financial Times, 3/31/14, p1), more than doubling in 2013 relative to 2012. China's premier warned that future defaults on bonds and other financial products are "unavoidable" (Financial Times, 3/14/14, p1). The IMF's Global Financial Stability Report (April 2014; see Table 1.4 and Table 1.5) places gross household debt at 32pc, up 13.6 percentage points of GDP since end 2008. Nonfinancial corporate debt stands at 141pc, a sharp gain of 42.0 percentage points since end 2008.

China's Article IV Consultation (6/5/14) underlines the likelihood that the credit/debt situation for China as a whole has deteriorated in recent years. "Since the Global Financial Crisis, activity has been too dependent on credit and investment, including in real estate. While this has supported growth in China- and provided a welcome boost to global demand- it is not sustainable and the cause of rising vulnerabilities." Such vulnerabilities are in shadow banking and local government debts. Despite the Chinese government's addressing these problems, "continuing reliance on credit-fueled growth means that risks are still rising". Even though the government retains "sufficient buffers to prevent a disorderly adjustment and sharp growth slowdown in the near term, continued efforts to reduce vulnerabilities are a high priority."

Interestingly, the IMF does not refer to China's capacity for avoiding disorderly adjustment and growth slowdown in the medium or long term if the current worrisome trends continue. Like the Fed, the Chinese government probably lacks a clear exit strategy for its highly accommodative policies. Anyway, the IMF proclaims China's need to "rein in excessive credit growth". China should implement fiscal reforms (especially local government finances), tax reforms, and financial sector reforms.

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According to the IMF's WEO, China's consumer price inflation will be 3.0pc in 2014 and 2015 (Table A7). This level probably is not worrisome for Chinese economic growth. However, suppose US government interest rates increase because the Fed remains steadfast in its quest for sufficient inflation of around two percent. There have been hints of rising US inflation in recent months. The May 2014 US consumer price index rose .4pc, increasing 2.1 percent over the last 12 months. A sharp upward move in Chinese rates probably would slow that country's growth.

Chinese central government rate trends do not mirror those of the US Treasury landscape. However, the Chinese 10 year central government note established an important interim low at 3.24 percent on 7/12/12, close in time to the UST 10 year note's 7/25/12 major bottom at 1.38pc. The UST 10 year's recent yield highs were 9/16/13 at 3.01pc and 1/2/14 at 3.05pc. Compare the timing of tops in China's central government note: 4.70pc on 11/21/13 and 4.68pc on 1/7/14.

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China holds about $1.26 trillion in UST securities as of April 2014, down modestly from $1.32tr in November 2013 (US Treasury International Capital Report, 6/16/14). Most of China's UST assets probably rest in its official sector.

CHINESE STOCKS

Trends in the Chinese stock marketplace since August 2009 do not parallel the China GDP growth story. However, the major bear move in the Shanghai Composite Index suggests that clairvoyants should be skeptical regarding prospects for further wonderful great leaps forward in Chinese GDP growth.

The Shanghai Composite peaked 10/16/07 around 6124, around the time of the S+P 500's 10/11/07 summit at 1576. After crashing to 1665 on 10/28/08 (S+P 500 major bottom 3/6/09 at 667), it flew up to 3478 on 8/4/09. That height obviously falls well underneath 2007's pinnacle over 6100. Significantly, the Shanghai Composite's highs have drifted lower and lower since August 2009. For example, see 4/15/10's 3181, 4/18/11's 3067, 2/27/12's 2478, 2/18/13's 2445, and 12/4/13's 2261. The low in the major bear move since August 2008 is 6/25/13's 1850.

TOUCHING BASE METALS

China is a major consumer of base metals such as copper. Since 2011, the London Metal Exchange's benchmark base metals index has fallen downhill. Though many factors influence metals prices, this pattern warns of some Chinese economic weakness (slower GDP growth). The LMEX peaked at 4478 (2/14/11)/4469 (4/18/11), with lower highs at 3820 (2/9/12), 3614 (2/4/13), and 3226 (8/16/13).

CHINESE CURRENCY CONCERNS

The Chinese leadership's willingness to engineer a weaker Chinese currency probably in part reflects concerns about weakening GDP growth.

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Many marketplace players focus closely on the Chinese renminbi versus US dollar cross rate. According to the Federal Reserve, China is 20.8pc of the broad real trade-weighted dollar. In 2000, it weighed only 7.9pc and merely 3.0pc in 1990.

The US dollar gradually depreciated against the renminbi over the past few years. The renminbi steadily rallied from its 9/2/10 low at about 6.818 versus the dollar. Another key trough for the renminbi was 7/25/12's 6.396. By the way, the US government 10 year note made a major bottom that day at 1.38 percent. Also, the Euro FX made a major low against the US dollar on 7/24/13 around 1.204. Anyway, the Chinese currency marched upward from its lows around 6.250 (12/12/12's 6.257 and 2/20/13's 6.249) as well as 6/27/13's 6.152 and 11/4/13's 6.116.

The renminbi rallied about 11.4pc from its 9/2/10 low to a top at 6.039 on 1/14/14. However, over the next three and one-half months, the renminbi retreated rapidly from that high versus the greenback, falling about 3.8 percent to reach it 6.267 low on 4/30/14.

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Although most observers focus on the Chinese renminbi's various cross rates, the growing international strength of China's economy manifests itself in a review of its currency trend on a trade-weighted basis.

The Bank for International Settlements (”BIS”) provides broad real (CPI based) Effective Exchange Rate indices for many currencies (monthly averages, 2010=100), including China's. Chinese data stretches back to January 1994. The current weights for key nations in the BIS's China EER index include the US at 19.0 percent, Japan's 15.9pc, Korea's 7.9pc, with 19.4pc for the Euro area (UK is another 2.8pc), and Chinese Taipei (Taiwan) at 5.8pc.

For many years, the Chinese EER generally rallied. In addition to the China EER low at 73.7 in April 1995 (65.6 in January 1994), see the one at 81.9 in December 2004. The China EER then advanced strongly to a key high of 107.4 in February 2009 (shortly before the S+P 500's March 2009 major low). The renminbi EER slipped to a trough of 95.6 in November 2009. It nevertheless decisively ascended over 100.0 beginning in June 2011 (it had briefly edged above it in the preceding months). It thereafter charged to its record high of 121.2 in January 2014 (May 2014 is the most current BIS data month).

The long run appreciation from December 2004's 81.9 bottom to January 2014's 121.2 height was monumental, about 48.0percent. The 26.8pc advance from November 2009's 95.6 floor to the January 2014 elevation was substantial.

However, the Chinese EER deteriorated after January 2014. Its May 2014 level is about 114.1, a 5.9pc decrease.

Despite the renminbi's decline since its January 2014 top, the IMF's Article IV Consultation indicates that "the real exchange rate is moderately undervalued" (6/5/14).

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See "Another Marketplace Tapering Tale: the China Story" (9/9/13) and "Chinese Rates: Opening the Gates" (12/2/13) for further analysis of China issues.

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