January 19, 2016

Economics Group

Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274
Erik Nelson, Economic Analyst
erik.f.nelson@wellsfargo.com • (704) 410-3267

China GDP: Slowdown or Deterioration?

Executive Summary

Economic growth in China has clearly slowed over the past few years, and data released this morning indicated the slowdown continued in Q4 2015. Full year growth for 2015 ended up roughly half a percentage point below the rate registered in 2014, with most of the deceleration concentrated in the country's industrial and construction sectors. Meanwhile, output in the services sector actually accelerated last year, consistent with Chinese authorities' explicit goals.

Looking ahead, we expect the slowdown in overall Chinese real GDP growth will continue. That said, we remain of the view that the downward adjustment will be gradual and orderly. Policymakers have a great deal of flexibility that should allow them to shore up economic growth should downward pressure intensify. As a result, we do not believe a deep recession is in the cards for China in the near future.

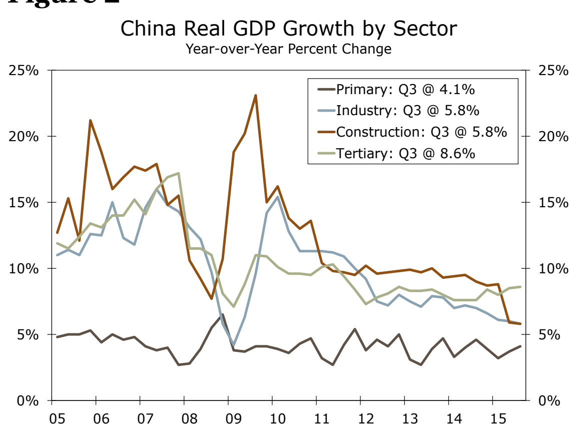
Real GDP Growth Inched Lower in Q4 2015

Data released today showed that real GDP in China rose 6.8 percent on a year-ago basis in Q4 2015, which was slightly below the consensus forecast (Figure 1). For full-year 2015, China's economy notched a 6.9 percent growth pace, below the 7.3 percent figure registered in 2014. Looking ahead, we expect that Chinese economic growth will continue to slow on balance in the coming quarters. Our current forecast calls for 6.3 percent growth this year and 6.0 percent in 2017. As long as the moderation in growth remains in place, investors likely will maintain a laser focus on the extent of the slowdown in the world's second largest economy.

Chinese GDP growth likely will continue to slow.

Figure 1

Figure 2



Source: Bloomberg LP, CEIC and Wells Fargo Securities, LLC

A breakdown of the Q4 real GDP data into its underlying demand-side components is not readily available at this time, but disaggregation into major industries offers some insights into the state of the Chinese economy at present. In that regard, growth in the "secondary" sector, which includes manufacturing and construction, held fairly steady in the fourth quarter. However, much of the slowdown in Chinese GDP growth that occurred last year was concentrated in this sector (Figure 2). Indeed, output in the secondary industry rose just 6.0 percent in 2015, down from 7.3 percent in 2014 and well below the double digit rates registered just a few years ago. Furthermore, higher frequency indicators suggest this trend will likely remain in place going forward. In particular, fixed asset investment growth slowed to 10.0 percent on a year-to-date year-over-year basis in December, down from 10.3 percent in September, while industrial production growth also ratcheted down over the month.

Service sector output has remained resilient.

Meanwhile, while growth in the services industry inched lower on a year-to-date year-over-year basis in Q4, services growth picked up for full-year 2015 to 8.3 percent from 7.8 percent in 2014. Moreover, higher frequency indicators suggest momentum in China's services sector largely remains intact. Indeed, real retail sales accelerated in the fourth quarter, a welcome respite for Chinese authorities who have made it their explicit goal to shift the country's growth engine from exports and manufacturing to private consumption. With so much angst among investors at present regarding the Chinese economy, we drill down further into these major sectors in an attempt to ascertain the outlook for the Chinese economy in 2016.

Construction Sector Indicators Point to Stabilization

As noted above, growth in the Chinese construction sector clearly has slowed over the past few years. That said, there are some glimmers of good news regarding the outlook for construction. First, house prices, not only for new houses but also for existing houses, are starting to inch higher, which suggests that demand for housing may be firming. Prices of existing homes in the country's 70 largest cities are up nearly 2 percent on average since the beginning of 2015 (Figure 3). Beijing, Shanghai, Shenzhen and Guangzhou have experienced double-digit price increases over the past 12 months, but higher prices for existing houses have not been limited solely to these "first-tier" cities.

Figure 3

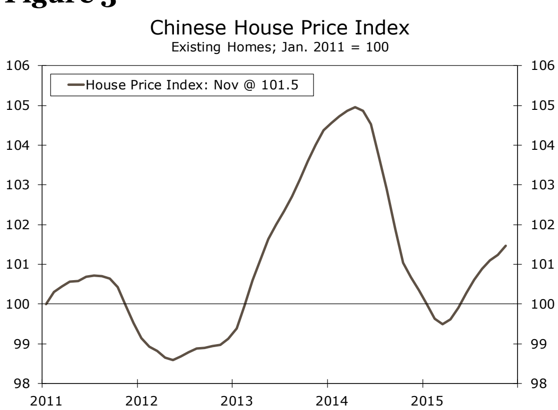
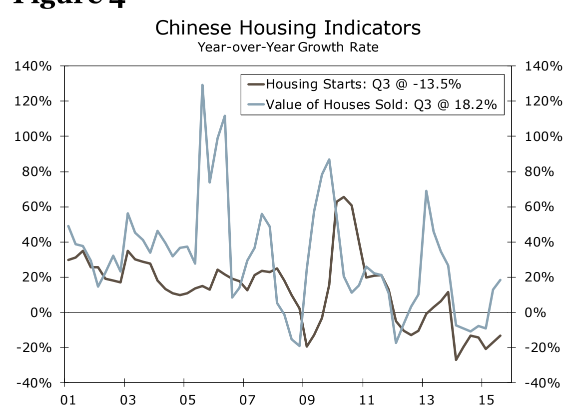


Figure 4



Source: CEIC and Wells Fargo Securities, LLC

A collapse in construction output does not look imminent.

Second, the value of home sales is starting to strengthen (Figure 4). Although the increase in the value of home sales clearly reflects higher prices, anecdotal evidence suggests that the number of home sales is rising as well.[1] If the past historical relationship continues to hold, then an increase in the value of home sales should eventually lead to stabilization, if not an outright increase, in the number of housing starts (Figure 4). As we discuss in further detail below, growth in bank lending remains solid, which should continue to support mortgage lending. Although growth in construction output probably will not return to the double-digit rates that characterized the earlier years of this decade (Figure 2), a collapse in the sector does not look imminent either.

[1] **"How Oversupplied is China Housing Market Really?", Forbes, January 12, 2016.**

Industrial Sector Should Decelerate Further

As shown in Figure 2, growth in the industrial sector has been slowing for the past few years. Slow economic growth in many of China's major trading partners in conjunction with trend appreciation of the Chinese renminbi has weighed on growth in real exports in China (Figure 5). Exports account for roughly one-quarter of the value of industrial output, so slow export growth has exerted headwinds on the Chinese industrial sector. In addition, investment spending in China has clearly decelerated in recent years (Figure 6), which also has weighed on growth of industrial output.

Figure 5

Figure 6

Source: CEIC, Bloomberg LP and Wells Fargo Securities, LLC

Growth in real retail spending, however, has been much more resilient than growth in real exports (Figure 5).[2] Not only do Chinese manufacturers export goods to foreigners, but they also sell product to domestic consumers. Growth in the industrial sector should remain positive as long as consumption expenditures hold up, a topic that we subsequently address further.

Slowing industrial growth is not entirely unwelcome by authorities.

That said, a return to double-digit growth rates in the industrial sector does not seem likely because resumption of supercharged rates of investment spending is simply not in the cards. Chinese policymakers recognize that prior emphasis on investment spending led to a dangerously out-of-balance economy, and they are attempting to transition the structure of the economy to one that relies more heavily on consumption expenditures.

Service Sector Remains Resilient

The service sector accounts for roughly 40 percent of value added in the Chinese economy and, as noted above, growth in the service sector remains solid. There are two purchasing managers' indices (PMIs) that attempt to measure the pace of activity in the service sector on a monthly basis. The service sector PMI that is compiled by the National Bureau of Statistics (NBS) has a longer record than the Caixin service sector PMI. Both PMIs have trended lower over the past year or two, although the NBS PMI hooked up in the last two months of 2015 (Figure 7).

There is a fair degree of correlation between the NBS manufacturing PMI and the NBS non-manufacturing PMI (Figure 8).[3] However, the manufacturing PMI tends to be more volatile than the non-manufacturing PMI, which reflects the larger cyclical swings that the manufacturing sector experiences relative to the service sector. When the industrial sector was weakening sharply in 2008-2009, growth in the service sector slowed but not as sharply (Figure 2 and Figure 8). Similarly, growth in the Chinese service sector in 2016 would slow if the industrial sector weakens significantly but it likely would remain positive.

[2] **We derive our proxy of real retail spending by subtracting the year-over-year rate of CPI inflation from the year-over-year growth rate of nominal retail sales.**

[3] **The correlation coefficient between the two indices since 2007 is 0.76.**

Figure 7

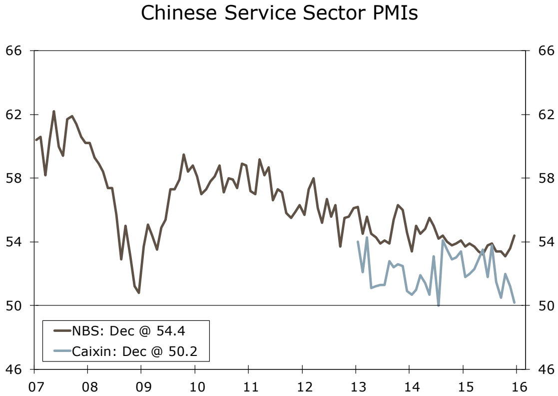
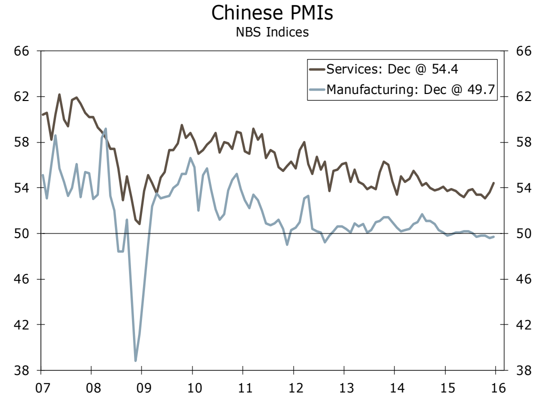


Figure 8



Source: CEIC, Bloomberg LP and Wells Fargo Securities, LLC

Income growth should support continued consumption growth.

Moreover, income growth appears to be solid at present, which should support continued growth in consumer purchases of goods and services. Median per capita income in the first three quarters of 2015 was up 10 percent relative to the same period during the preceding year. Income growth probably will slow in 2016 as growth in the industrial sector downshifts. As long as income growth does not completely falter, however, growth in consumer purchases of goods and services should remain solid.

Authorities Have Policy Flexibility

Our forecast calls for real GDP growth in China to slow from the 6.9 percent rate that was registered last year to 6.3 percent in 2016 and 6.0 percent in 2017. We readily acknowledge that economic growth in China could downshift more sharply than we anticipate, but we do not believe that a deep recession in China is imminent. Chinese authorities have policy flexibility to respond to economic weakness.

For starters, the central bank's 1-year benchmark lending rate currently stands at 4.35 percent, which gives the People's Bank of China (PBoC) the ability to cut rates by more than 400 bps, if necessary (Figure 9). In addition, the required reserve ratio for major banks is 17.50 percent at present. When capital was pouring into China a few years ago, the PBoC jacked up its required reserve ratio to neutralize some of the excess liquidity that was sloshing around the banking system at that time (Figure 9). Now that capital is leaving China, the PBoC has the wherewithal to cut the required reserve ratio significantly to support the ability of banks to make loans. In that regard, growth in bank lending is holding up just fine at present (Figure 10).

Figure 9

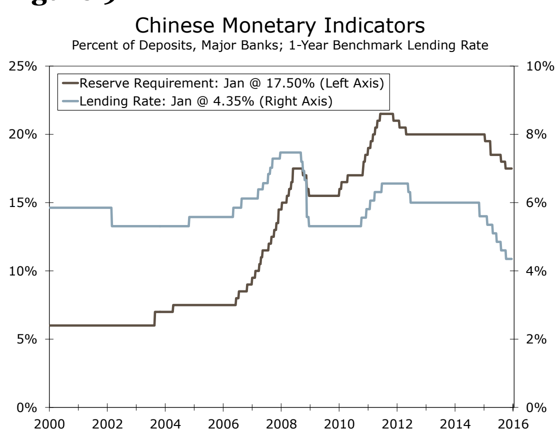
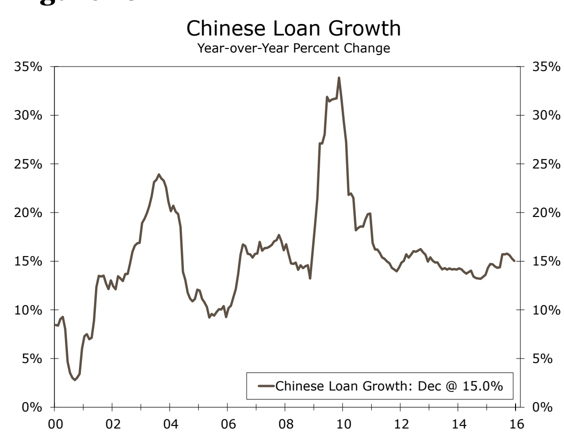


Figure 10



Source: Bloomberg LP, CEIC and Wells Fargo Securities, LLC

Furthermore, with a debt-to-GDP ratio of only 15 percent or so, the central government in Beijing has the ability to ease fiscal policy to support the economy. In 2008-2009 the government eased economic policies in a wholesale fashion. That is, it accelerated about CNY 4 trillion (roughly $600 billion at the exchange rates prevailing at that time) worth of infrastructure spending that had been slated for later years, and it directed banks to significantly increase lending (Figure 10). The sharp increase in lending that occurred at that time may be one reason, among many, that the Chinese economy is experiencing some problems today. Therefore, the policy accommodation that has been implemented over the past year or so and any further easing measures that will take place likely will occur at the margin rather than in a wholesale fashion.

Additional easing measures likely will occur at the margin.

Conclusion

Chinese economic growth slowed slightly more than expected at the denouement of last year, which may tempt some observers to fear the worst for the world's second largest economy. However, while we expect the downward trend in growth to remain in place, we remain of the view that the adjustment will be gradual and orderly. As the industrial sector continues to lose steam, the services sector should remain resilient and underpin overall growth going forward. Meanwhile, authorities in China have substantial policy flexibility that should allow them to respond to any significant increase in downward pressure on economic activity, should it occur. Accordingly, we do not believe a "hard landing" is in the cards for China any time soon.

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com

WELLS FARGO SECURITIES