



Client Bulletin

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Robert C. King
Senior Economist

China Pickup May Prove Real But Not Lasting

After months of deceleration, Chinese economic data have shown signs of a sudden improvement this summer. Although the pickup in some of the data may be noise, there are positive signs from enough different sources to suggest a real acceleration in activity, likely reflecting some moves by policymakers under pressure to once again increase stimulative programs. Yet with Chinese leaders increasingly wary of the financial, environmental, and political consequences of continuing aggressive deficit spending and credit extension, Chinese stimulus is likely to come in fits and spurts. Over the next few months the economy may show more signs of a pickup stemming from policymakers' latest attempt to halt the growth deceleration. The improvement may prove fleeting or it may last a couple of quarters.

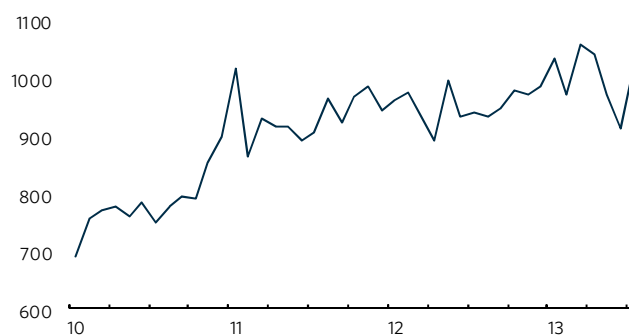
The bigger picture is that China's long-term problems continue to fester. It is struggling to cope with: (1) the loss of a growing trade surplus (which had been an ever-expanding profit source), (2) massive overcapacity and an unsustainably lopsided dependence on fixed investment as a source of profits, and (3) burgeoning financial complications from a frenzied expansion of credit that ran into a growth slowdown.

Although the reliability of official Chinese data is suspect, the breadth of news of improvement, including corroborating evidence from private sector reports and from industrial commodity prices, is persuasive. Both Chinese and some foreign equipment makers have reported signs of stabilization in Chinese demand, and the Chinese government reported that spending on new fixed investment projects rose sharply in July. Nominal Chinese imports jumped in July after three straight months of decline (chart 1—note: we refer to a seasonally adjusted series provided by Haver Analytics; the official unadjusted data are impossible to compare month-to-month) and

global iron ore prices have risen 25% in just the past 6 weeks (chart 2), suggesting a rebound in Chinese demand for steel. Year-over-year production of electricity accelerated in July (chart 3). Modest stimulus steps announced by Chinese leaders—including increased railway construction, easing of some regulations on exports, and financial support for local governments—may be behind the improvement.

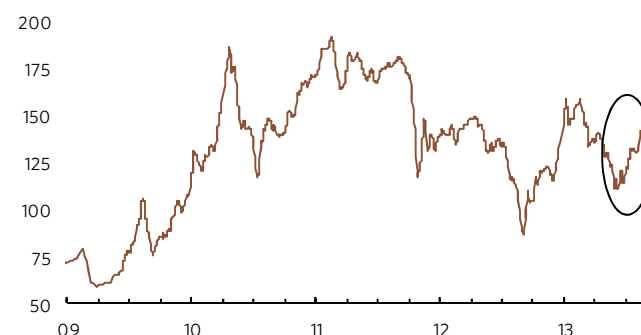
Volatile Trade Data Show Import Jump in July CHART 1

China Goods Imports
billions of yuan, seasonally adjusted by Haver Analytics



Iron Ore Prices Rose Sharply in Recent Weeks CHART 2

Iron Ore Prices at Tianjin Port, China
\$ per dry metric tonne, daily data through August 13, 2013



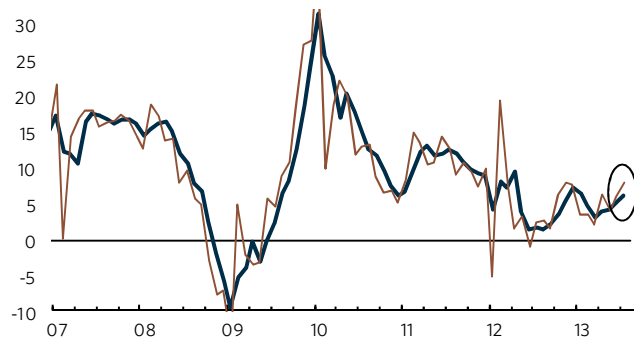
However, the latest data on credit growth are not consistent with the pickup in economic activity reported elsewhere. Total social financing—the broadest measure of credit growth, which includes both direct bank lending and off-balance-sheet lending, and lending to both private and government borrowers—weakens noticeably in the three months ending in July (chart 4). Policymakers are clearly struggling with the dilemma of (1) needing a credit acceleration to support growth in the short term and (2) fearing the long-term instability resulting from rapid credit expansion. As we wrote in July, “Chinese financial conditions are likely to become increasingly volatile as policymakers see-saw between providing liquidity when events threaten to go over the brink and attempting to rein in credit

when the situation appears calmer.” The financial sector is clearly in flux and remains at serious risk of dislocation.

EM stocks, especially those of commodity producers and exporters, have surged on recent indications and hopes of reviving Chinese imports. What is happening in China may largely determine how long these markets can run. We maintain our view that the EM economies broadly as well as China’s in particular face daunting adjustment pains as they try to find their way without ever-soaring export sales to the advanced economies, and we expect EM economic performance to remain generally disappointing over the next few years. However, in the short-term their prospects may appear brighter.

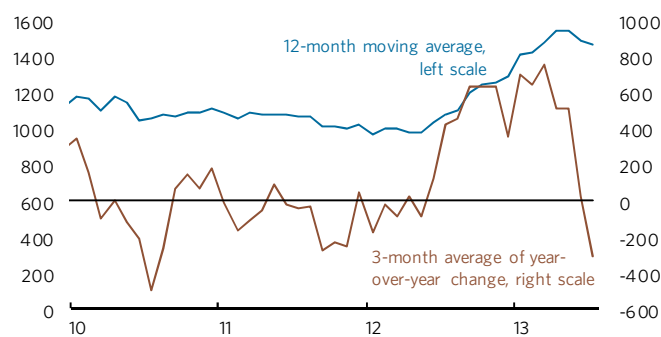
Electricity Production Growth Accelerates CHART 3

China: Electricity Production, All Sources, year-over-year % change (thin line) and 3-month average of year-over-year % change (thick line)



Monthly Credit Growth Not Confirming Rebound CHART 4

People's Bank of China: Total Social Financing ex. Equity Financing billions of yuan, monthly through July 2013



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Contact Douglas Williams: DWilliams@levyforecast.com (914) 666-0641

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