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October 10, 2014 6:21 pm

Too many unanswered questions over Chinese growth

By Merryn Somerset Webb

Evidence of a sharp slowdown is obvious

Millions of Chinese are planning to leave China. Why? Where are they going? What do they plan to do? The FT is running a series exploring this (Silk Road Redux). Run your eye down the list of nationalities taking advantage of the "golden visa" schemes across Europe and you will find that the majority of those buying relatively expensive property to be able to apply for residency are Chinese – 81 per cent so far in Portugal's scheme.

That might be just about the nice weather in Lisbon, the semi-democracy offered by the EU and the lower levels of air pollution in the west. But it might also be to do with the fact that China's economy isn't quite what it was.

There have been dire warnings for some time on the nasty ending awaiting what some call "the Chinese growth miracle" and others call "the Chinese credit bubble". But it is now hard for even the most optimistic observer to escape the evidence of a sharp slowdown.

The China Beige Book, a quarterly analysis modelled on the Federal Reserve's commentary on US economic conditions, aims to get to the bottom of what is happening in China.

It ignores the official data in favour of tracking the fortunes of thousands of companies across the economy. The results from the second quarter of this year made miserable reading. They showed slowing growth across the board and exceptionally weak capital expenditure – "not one sector showing quarter on quarter improvement".

Silk Road Redux

The road from China to Europe has become engorged with cash since the onset of the eurozone crisis in 2009. As other investors fled, Chinese companies bought world-class brands and wealthy Chinese found it easier to gain EU residency

Given that growth in the Chinese economy has been mostly driven by an addiction to over-investment for years, this weakness has pretty sweeping effects: the "withdrawal symptoms will not be pretty", it says. The just-released Beige Book for the third quarter doesn't give much room for hope either. Capex growth fell again with the "share of firms both applying for and receiving loans stuck at rock bottom levels".

This is not exactly surprising. But it is useful information for those of us who, like me, have been wondering about piling into the commodities that have collapsed in price on the back of falling global demand. It tells us that we might be a bit early. This brings me on to something boring but important: "collateral trade" in China. This sounds complicated and it is.

At a financial industry dinner earlier in the week I asked every person I spoke to if they could explain it. No one could. They might soon wish they had paid more attention.

A paper from chemicals consultancy International eChem gives a good overview of how it works and there are various mind-boggling schemes in use. But the key point is that the trades involve commodities of all types (metals in the past and more recently chemicals) being shipped to China and used as collateral via the shadow banking system to finance other investments offering higher returns – in particular, property. They have been one of the key drivers of credit creation.

Investors in commodities might have believed that everything imported into China was used for something productive. But Paul Hodges of International eChem says many of the imports have just been stockpiled for financial engineering. Some estimates suggest that 100m tonnes of iron ore is tied up in finance deals. That's all been fine while China has been growing fast – who cares about the complications when everyone's making money? But with the property bubble deflating, it matters now. Not only can deals fail as property prices and liquidity fall off but the government has announced it has found some $10bn of fraud in trade finance and ordered a tightening of systems.

This, says Mr Hodges, suggests the "moment of truth" for commodities may be near. Falling capital expenditure means that China doesn't need natural resources like it used to and the "vast stockpiles" it was only ever going to use as financing instruments "may soon be released back on to the open market" too. The unwinding won't be pretty.

Beyond Brics

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- Merryn Somerset Webb

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Still, if you are a typical modern stock market investor, all this talk of moments of truth and the like won't bother you at all. You will simply assume that bad news is good news and that slow growth or some kind of financing meltdown will mean more monetary stimulus from the Chinese authorities, who have past form when it comes to credit creation.

That might not be the correct assumption this time around. Not only have the authorities made it fairly clear they aren't planning major stimulus, but the Beige Book for the third quarter also makes the point that there isn't really any excuse for stimulus. The labour market is fine and wage inflation has eased, "allowing profit margins to grow at the healthiest pace in more than a year". China might be having a nasty secular slowdown but the employment situation isn't bad enough for the authorities to give global investors the flood of money they would like.

It is also clear that more stimulus in China won't do much for the real economy. For years the Chinese government has force fed mining and the manufacturing industries on a rich diet of cheap capital. Excess capacity of 40 to 50 per cent in just about everything is the norm, says Anne Stevenson Yang of J Capital. So stimulus to these industries "cannot create demand-driven growth". The authors of the Beige Report agree. Supply is there, but as is always the case when bubbles end, demand is not – so there is no point in offering more supply.

The clear message from all of this is that we should continue to steer clear of assets that rely on Chinese economic growth, and in particular investment growth, for their success. This doesn't necessarily include all Chinese equities. However, it does include most commodities. It also includes pretty much anything in Australia – which is very reliant on mining – and, among other things, the multiple booms in high-end property markets worldwide. If there isn't as much money to come out of China as there once was, new expats may well head for low-budget Lisbon rather than costly Kensington.

India and China – clash of the titans

Indian shares are notably more expensive than Chinese ones – so which country makes the better investment prospect?

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