Economics Group

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Slower GDP Growth in China Here to Stay

Real GDP in China grew 7.5 percent on a year-ago basis in the second quarter, which is rather slow by Chinese standards. However, the government is not unhappy with this slower pace of growth.

Q2 GDP Growth in Line With Consensus Estimates

Real GDP in China rose 1.7 percent (not annualized) on a sequential basis in the second quarter. The outturn, which was in line with the consensus estimate, took the year-over-year growth rate down to 7.5 percent from 7.7 percent in Q1 (top chart). China does not release a breakdown of real GDP into its underlying demand components on a quarterly basis. However, monthly data provide some clues into the source of the recent slowdown in China. For starters, export growth remains weak (middle chart). Real GDP growth in the Eurozone, to which China sends about 15 percent of its exports, has been very weak, and economic growth in many other trading partners, including the United States, has been sluggish.

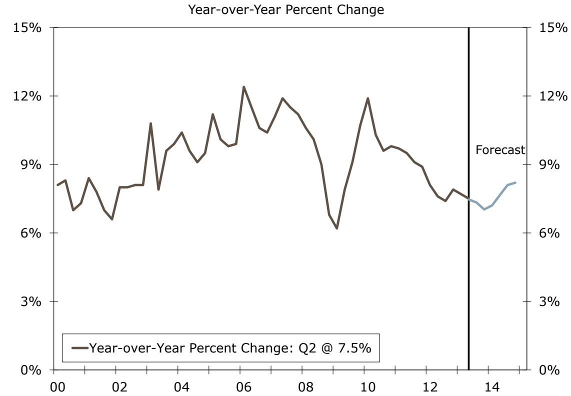
But, there are domestic factors behind the slowdown as well. Chinese economic growth over the past few decades has been driven in large part by robust growth in investment spending. Chinese authorities have concluded that the economy has become unbalanced, and that they need to reign in capital spending or risk a "hard landing" at some point due to excess capacity. Although investment is currently up 20 percent on a year-ago basis, this seemingly robust growth rate is actually relatively slow by the standards of the past decade.

Moreover, it appears that the government is not about to let up on its attempt to achieve slower growth in investment spending. Last month, the central bank allowed interbank lending rates to spike. Some analysts used the term "credit crunch" to describe the episode. Although interbank rates have subsequently receded, the message was sent (and received) that the government is attempting to curb excessive lending in the so-called "shadow banking system." As shown by our forecast in the top chart, we project that real GDP in China will continue to grow less than 8 percent (For further reading on Chinese economic growth see our special report entitled "How Much Does Slower Chinese Growth Matter," which is available upon request.)

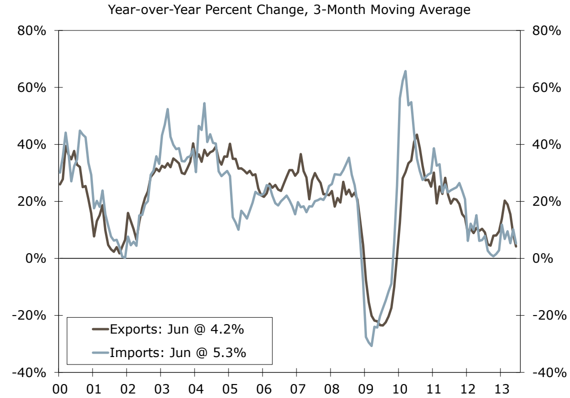
Renminbi Should Grind Higher Against U.S. Dollar

The massive build-up over the past decade or so of the country's foreign exchange reserves, which currently total roughly $3.5 trillion, represents another imbalance in the Chinese economy. Large trade surpluses and strong capital inflows lead to rapid growth in foreign exchange reserves, which make it difficult for the central bank to effectively control the country's money supply. In order to reduce the rate of reserve accumulation, the government has allowed the currency to appreciate gradually. Indeed, the renminbi has strengthened nearly 5 percent vis-à-vis the U.S. dollar over the past year, although it has stabilized in recent weeks (bottom chart). Looking forward, we expect that the renminbi will continue to grind higher versus the greenback.

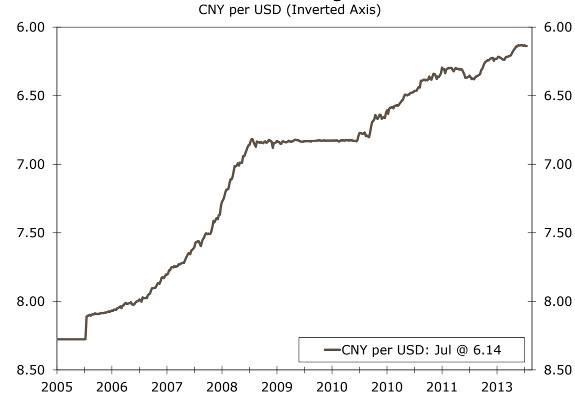
Chinese Real GDP Forecast
Year-over-Year Percent Change



Chinese Trade
Year-over-Year Percent Change, 3-Month Moving Average



Chinese Exchange Rate
CNY per USD (Inverted Axis)



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

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