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NEWSLETTER

China GDP: Growth, Propaganda and National Power

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"If you tell a lie big enough and keep repeating it, people will eventually come to believe it. The lie can be maintained only for such time as the State can shield the people from the political, economic and/or military consequences of the lie. It thus becomes vitally important for the State to use all of its powers to repress dissent, for the truth is the mortal enemy of the lie, and thus by extension, the truth is the greatest enemy of the State." – Joseph Goebbels.

If official statistics are to be believed 2020 saw the Chinese economy grow by 2.3% in real terms. It is an often-repeated statistic in the mainstream media and seldom carries a caveat. Has it been repeated enough for people to believe it? The last time the Chinese economy shrank was 1976. Hell, it appears, will freeze over before the Chinese economy undergoes what in other countries occurs frequently – an economic contraction. A global pandemic is insufficient to shrink the Chinese economy.

Questioning China's official GDP numbers is not a new phenomenon. Using data from 1997 to 2000, Thomas Rawski pointed out that China's energy consumption fell by 12% while its reported GDP growth was just shy of 25% - an unlikely outcome in his view (1). In 2012, Henderson, Storeygard and Weil set out to estimate economic growth by comparing levels of luminosity between countries with poor economic data between 1992 and 2006. They concluded that China's economic growth – reported at 122% - was actually 57%. (2) Such studies are not perfect, but they point to the distinct possibility that over many years, China's growth numbers, even adjusted as they have been for exaggeration by local officials, have been overstated. Small annual overstatements can add up over the years to a big cumulative overstatement of the actual size of the economy. In 2019, the

Brooking institute undertook a forensic examination of China's national accounts and concluded that growth was being overstated by about 1.7% per year between 2008 and 2016 (3). Their study suggested that adjustments to local government data were not large enough to compensate for the level of exaggeration. Critics of the study, notably the Peterson Institute, while disputing the size of the overstatement, did not object to the main finding, merely suggesting that maybe an annual overstatement of 1% was nearer the mark (4).

Back in the 1990s, China's GDP was an all-but-irrelevant part of the global economy. Today, overstated or not, China's GDP is now a large part of it. It is therefore more important that we have the true picture as to what is actually happening. Furthermore, as China's capital markets become more integrated into the global system, economic data assumes an importance to the financial system that was absent before. Markets thrive on the provision of accurate, timely information. In the absence of good data, capital gets mis-allocated to the detriment of efficiency, and growth suffers. As foreign investors pour billions of dollars into China's capital markets, driven by the prospect of a percentage point or two of yield pick-up, it is worth considering if they are doing so with enough good information to make a rational decision or are they absorbing propaganda.

Between 2012 and 2018 (the last year for which a lot of microeconomic data is available), China's economy is reported to have grown in nominal RMB terms by 74%, or a 9.7% Compound annual growth rate. Tax revenue grew by a more sedate 48% (6.7% Cagr) and corporate profits, as measured by the Industrial enterprise survey, grew by just 7% (1.2% Cagr). Wages did supposedly grow in line with official GDP numbers at 9.5% and 9.9% for private and non-private sectors respectively. Applying normal weights to these factor incomes would suggest nominal growth of perhaps 7.5% rather than 9.7%.

Bringing these numbers up to date where possible, corporate profits supposedly shrank 3.3% in 2019 and rose 4.1% in 2020, meaning they have now grown at just a 0.5% Cagr since 2012 and the corporate profit to GDP ratio has more or less halved since 2012 from 11.7% to 6.2% if one takes the GDP number at face value. The minimum wage (for Shanghai) was unchanged in 2020 over 2019 and 2019 was up just 2.5% on 2018. While this is not the same as the average wage, it maybe indicates a large slowdown in wage growth. For what it is worth, the household survey for 2020 showed nominal urban wage growth at 3.5% year on year. VAT revenue fell 8.9% in China in 2020 after growing just 1.3%in 2019. Overall tax revenue was down about 2.5% in

2020 from 2019 and 2019 was up just 1% on 2018.

The bottom line from the above is that, with the tax take and industrial profits flat to down in 2020 from their level of 2018, and wage growth over the two years in the region of say 5%, it is unlikely that nominal GDP growth in China over the two years exceeded 2% pa, and real growth over the two years may well have been about zero – modest growth in 2019 offset by a modest decline in 2020. This of course is not bad by international standards given the pandemic, but it is not what we have been told happened and not what many investors believe happened.

The road less travelled

Microeconomic data can be used to paint a gloomier picture. With household incomes supposedly growing at nearly 10% pa over the past decade or so, it is perhaps surprising that with so many roads (4.8m km) and such a low car penetration rate (41% in households in urban areas and 22% in rural areas), that passenger car sales in 2019 (pre-pandemic) were down 13% at 21.4m from their 2017 high of 24.7m. The fall to 19.3m in 2020 is understandable in the global context of the pandemic but does not sit happily with the 2.3% real growth China supposedly enjoyed. While it is tempting to point to Government policy, rather than economic conditions, to explain away the car sales disappointment, smartphone sales, according to The China Academy for Information and communications, fell 20% in 2020 which followed on from a 4% decline in 2019 and smart TV sales also fell in 2020 by 4%.

The consumer services sector is of course where the structural growth may be, and optimists would say that the low growth numbers for "stuff" hide the growth in experience-based consumption. The pandemic though impacted the "experience" market the most. Cinema box office takings were down about 65% for example. Beer sales have been stagnant in volume terms for several years – even in 2018 they were 8% below where they were in 2012. The catering industry, whose revenue had been growing very fast, shrank by 16% in 2020.

As we know investment makes up an abnormally large part of China's economy and therefore, with consumption down year on year, investment must have grown for the overall economy to have grown. In January 2020, the NBS announced that Fixed Asset Investment in 2019 had grown 5.4% to RMB55.1 trillion. In January 2021, the NBS announced that FAI had grown in 2020 by 2.9% YoY to RMB51.89 trillion (implying a base of RMB50.4 trillion which is 8.5% below the reported base from 12 months prior). In 2018, FAI was originally announced at RMB63.6 trillion a number 22.5% above the 2020 number yet in no year is it reported to have shrunk! While all statistical offices make adjustments, this is so large as to change the polarity of this, and previous years, growth numbers. The RMB51.89 trillion of FAI represents a 5.8% decline on the previous year's originally announced numbers. Combining that with the official household survey consumer expenditure number – a nominal decline of 1.6% - would suggest a nominal GDP contraction in 2020 of perhaps 3 to 4%.

So why does it matter that China appears to be systematically over stating it GDP number, perhaps to the cumulative amount of 15-20%? The obvious point is that the size of the bond market and the bank loans outstanding are presumably fairly accurate. The debt to GDP ratio is therefore understated and the ability of the Chinese economy to carry the debt burden overstated. As we point out in our latest monthly, the amount of liquid (excluding FDI) financial assets now owned by foreigners in China, and therefore theoretically free to leave (for now at least) has grown rapidly to about USD2.9 trillion. China's foreign exchange reserves have not grown with the portfolio inflows and now stand at USD3.1 trillion. In short, China's overseas assets have become less liquid while her liabilities have become more liquid. A sharp reversal of foreign portfolio flows could therefore either force the PBoC to deflate their balance sheet and the economy with it, or stand aside and let the RMB fall. With yield spreads thin, and even smaller after hedging costs, the incentive for foreigners to stay is starting to diminish. What appears to be going on is that China's economic data has been weaponized: it has become part of the propaganda war. The Party see economic success as an important legitimizing force. Economic "failure" therefore threatens the power and integrity of the Party. The truth, as Goebbels realized, is "the enemy of the State". Those who repeat the official statistics for want of a better alternative are unwittingly part of the propaganda machine.

Geopolitically and morally challenged.

While official economic statistics, at face value, give foreign investors in China confidence they are investing in a rapidly growing and robust economy, ESG and jurisdictional considerations seem increasingly to argue for an exit. In "Investing in Cold War 2" we argued that geo-political competition between China and democracies would lead to the increasing politicization of economic engagement with China. Companies that tried to span both geo-political blocs would become challenged and suffer as a result – being forced to choose where they did business. The change of administration in the United States has done nothing to change our view that this is the direction in which we are heading. In addition to rising jurisdictional risk, which drives a wedge between the cost of capital faced by local investors and that faced by foreigners, there is rising reputational risk from the ESG lobby – one of our core "9 fault lines" that guides our research is that capital can no longer be amoral.

The question we posed back in November was "How has the genocide in Xingjian changed your investment strategy in China?" Clearly, the list of companies that are having to address this issue is growing and has now embroiled the textile industry. The core problem is how to appease two sets of consumers with conflicting perspectives, in this case on the use of cotton grown in Xinjiang. The short answer is that there is no middle way and, as the pressure builds with the evidence, companies will have to make hard choices as to where they wish to operate and which value system they wish to be associated with. As Goebbels pointed out, propaganda only works so long as the people can be isolated from the economic consequences of the big lie. Maybe the Chinese are finding out that their economy is not as invulnerable to the laws of economics as they have been led to believe; that consequently China's National power has been overstated; that Xi has overplayed his hand; and that the power of propaganda has its limits.

1) Rawski, Thomas G. "What Is Happening to China's GDP Statistics?" China Economic Review, Vol. 12, 2001, pp. 347-54. See http://dx.doi.org/10.1016/S1043-951X(01)00062-1.

2) Henderson, J. Vernon; Storeygard, Adam; and Weil, David N. "Measuring Economic Growth from Outer Space." American Economic Review, Vol. 102, No. 2, 2012, pp. 994-1028. See www.aeaweb.org/articles?id=10.1257/aer.102.2.994.

3) https://www.brookings.edu/wp-content/uploads/2019/03/bpea-2019-forensic-analysis-china.pdf

4)https://www.piie.com/blogs/china-economic-watch/chinas-growth-overstated-dont-rely-lower-tax-revenue-growth-evidence