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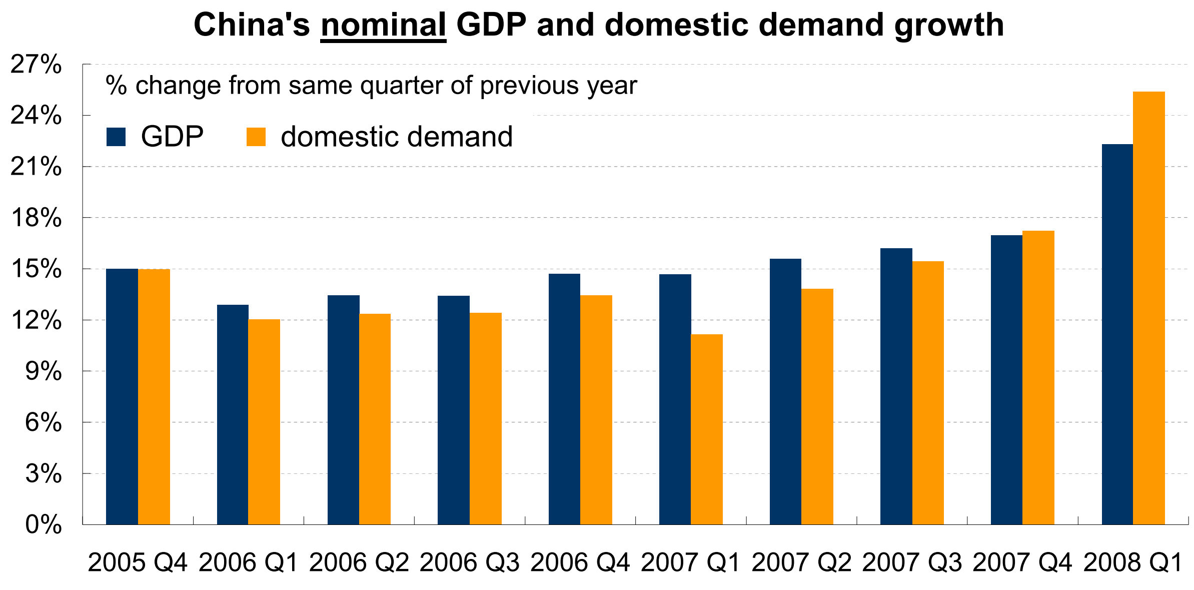
Chinese Q1 real GDP gain was 16-17%, not 10.6%

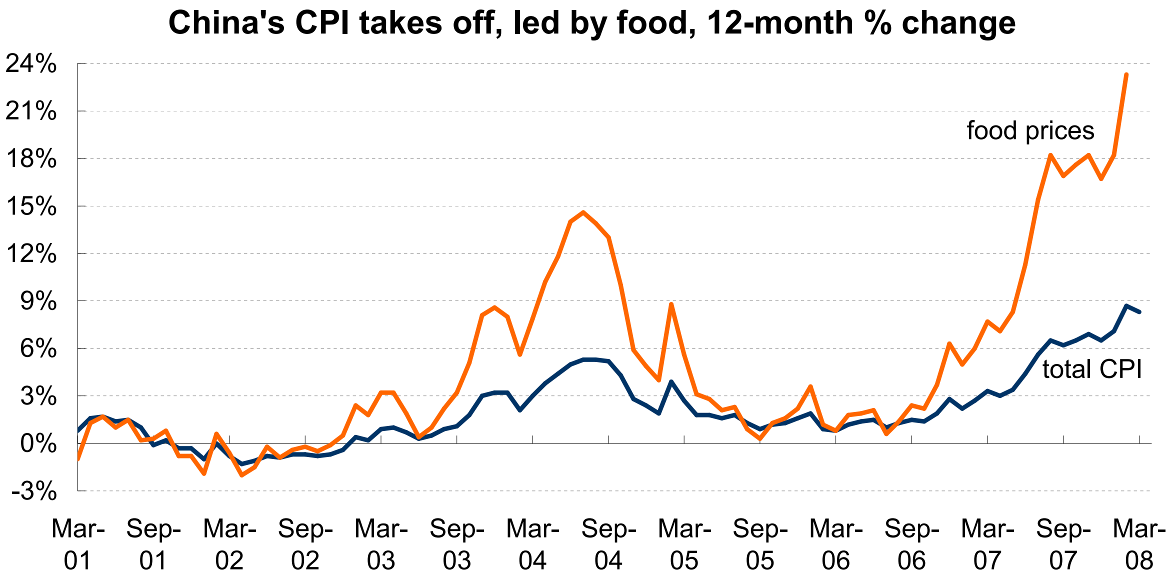
WE SUGGEST: Requirement for yuan appreciation now much greater

SUMMARY: Nominal GDP was up 22.3%, nominal domestic demand 25.4%. The 8%-plus CPI inflation rate is confined to food, so does not affect the half of demand that is non-consumer. The implied GDP and domestic demand inflation rates bring these nominal data down to below 17% in real terms, far above the official 10.6%. Rapid further yuan appreciation and freer capital exports are badly needed.

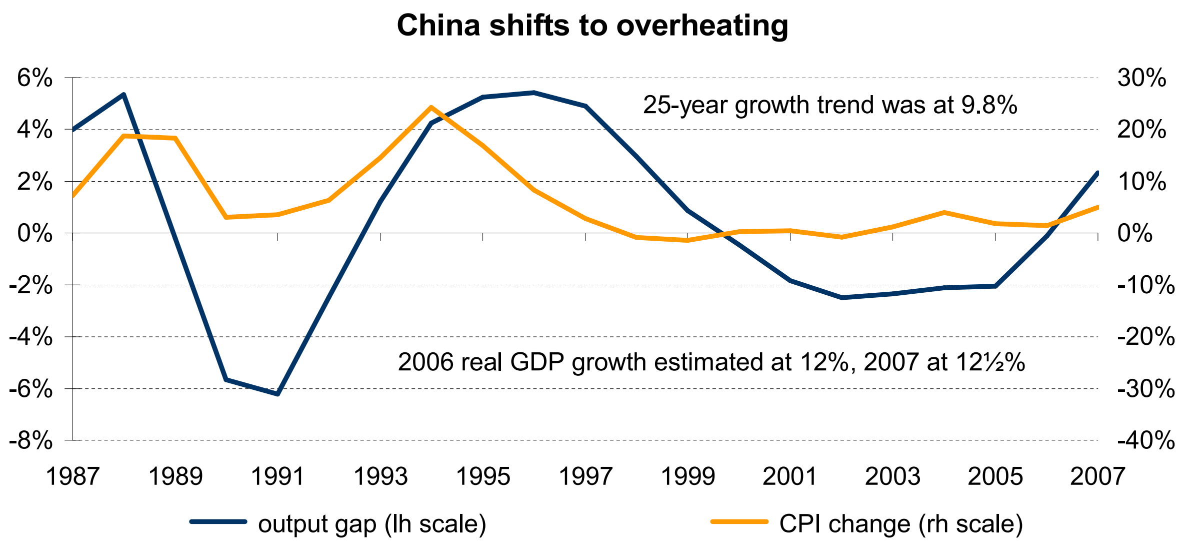
Today's official release of Chinese real Q1 GDP growth – claimed to be 10.6% – was even more politically correct(ed) than usual. The levels of real GDP are not given. The quarterly levels of nominal GDP are given, and show Q1 up 22.3% from 2007 Q1. This means real growth was radically higher than 10.6%, probably in the 16-17% range (see below). China is now overheating dramatically. The People's Bank of China responded by tightening bank reserve requirements a 50bp notch to 16%, and government spokesmen stressed the threat from acceleration. As well they might. The economy appears out of control.



Nominal GDP may have risen 22.3% in Q1 from the year-before number, but net exports were down. In dollar terms they fell by over a tenth (from $46.32 billion to $41.44 billion, unadjusted). In yuan terms they were off nearly a fifth. As a result, domestic demand was up by over 25% in nominal terms. The Chinese savings glut – over half the Asian glut and nearly a third of the Eurasian glut – is giving way to a burst of domestic overheating.



China's CPI rose by 8% in Q1 on average (8.3% in March). Food has a 37% weight in consumer spending, and applying that ratio to its much higher inflation rate accounts for the entirety of the CPI gain. This means that inflation outside of consumer spending was relatively small, though some effect from soaring oil and metal prices was probably felt. With consumer spending at about half of GDP and domestic demand, this suggests a 4-5% inflation rate for the GDP deflator, somewhat more for domestic demand. Using 5% for GDP inflation turns the 22.3% nominal growth into 16½% real growth. To get real domestic demand growth below 17% from its 25.4% nominal rate requires assumed inflation for domestic demand of over 7%, almost certainly too much.



Applying similar analysis to 2006 and 2007 GDP gave about a 2% output gap by 2007, as the 2002-05 slack in the economy was replaced by overheating. Given the acceleration over the past few quarters, the output gap by now could be over 4%. Q1 alone, with real growth more than 6% above trend (1½% per quarter) may have contributed 1½% to the positive output gap. Inflation should accelerate sharply in response to this, as it always has in the past. The 10% mark for inflation is highly likely soon, unless drastic measures are taken. The target growth rate of 8% is about 2% below trend and would get the output gap to zero by early 2010. But that would merely stop inflation accelerating from whatever level it had reached by then. To get it down again could require either slower growth than 8% for two years, or 8% for longer.

Apart from fiddling around the edges with controls and so forth, the government has the choice of accepting faster inflation, hammering domestic demand, or disinflating by letting the yuan rise faster. The choice is easy. Since policy changed in October, the yuan has risen 7% in six months, a 14-15% annual rate. The US slowdown will help concentrate the needed slowing on net exports, rather than unnecessary deflation of domestic demand, though some of that is also needed.

Freer Chinese capital exports would help. A shift of deposits from domestic banks could ensure a badly needed rise in interest rates. This would help cool an overheated economy, and remove some of the penalty for Chinese depositors getting 4-4½% rates against inflation of 8½% (going on 10%). Slower growth of FX reserves would lessen the creation of excess domestic liquidity. Money and credit have been growing by 18% for years now: it is small wonder the nominal GDP growth rate has finally accelerated above this rate. More than half the growth of broad money in cash terms is accounted for by funding the $480 billion accrual of extra foreign exchange reserves in the 12 months to March. The story that this funding is “sterilised” in a primitive financial system like China’s is just that: a story. With slower US imports and higher yuan shrinking the trade surplus, freedom for Chinese to export capital could quickly disinflate the monetary system.

The key word for Beijing to note is “quickly”!

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