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A DEEPER ASSESSMENT OF CHINA'S 2014 GROWTH

BY DANIEL H. ROSEN

Past Events

- **January 5: Asia Pivot 2.0 (CSIS)**

Upcoming Events

- **January 29: Asia-Pacific Forecast 2015 (CSIS)**
- February 9–10: G20 Finance Ministers and Central Bank Governors Meeting (Istanbul)
- February 19: Chinese New Year begins

Earlier this month, China reported 7.4 percent GDP growth for 2014, missing Premier Li Keqiang's 7.5 percent target but still defying predictions of inevitable deeper slowing. With an additional $800 billion in annual output, China joined the United States as only the second member of the 14-digit club—at $10.4 trillion in headline GDP—drawing China closer to peer competition with the United States despite a year of painful economic restructuring, harrowing political showdowns at home, and an external environment fraught with geopolitical risk and economic fragility. Growth in services was 8.1 percent, outstripping overall GDP growth and suggesting that the Chinese leadership can point to some progress in its effort to foster a rebalancing of activity in less over-capacity directions. Partly overshadowing that achievement are concerns about the sustainability of reform in 2015 and, based on a deep dig beneath the headline numbers, whether Beijing's statistical practices are introducing new reasons for skepticism.

According to Beijing's official data, 2013 was the first year services surpassed the secondary sector (industry and construction) to become China's largest sector, an important milestone for an economy long over-dependent on investment and heavy industry. Continuing growth in services helps Beijing lay claim to success for its reform efforts and is essential for mitigating employment pressures. Each unit of investment in services generates far more jobs than deploying capital in heavier industries. Rising services output also correlates more closely with household consumption, not to mention the promise of a cleaner environment. Seen in this light, China's 2014 growth story is not about coming up a fraction shy of a reference target set a year ago, but about green shoots of progress toward the goal of transition to higher value-added, cleaner, more labor-intensive services and industries.

However things are not that simple. An assessment of China's nominal GDP undertaken by my colleague **Beibei Bao** and me, in partnership with CSIS, provides new insights into China's economy that modify this picture. Our independent calculations suggest that services exceeded industrial activity as early as 2009. This means the services sector—which is, by any reckoning, the future of China's growth—does not suffer from insurmountable structural constraints so much as accounting problems that left it undercounted until recently, and most likely still today.

As a planned economy, China used the national accounting system favored by the Soviet Union to count GDP. The "Material Production System" (MPS) excludes most services from the definition of economic production. The MPS legacy saddled China with institutions ill equipped to capture service value when the country transitioned to the UN-endorsed System of National Accounts (SNA) in 1993. That institutional weakness, including staffing, inadequate legal and political mechanisms to assure integrity, and data quality concerns, still prevents China from fully measuring its service industries. Using real-economy metrics, comparator country data patterns, and adjustments based on the latest international GDP accounting standards, we recalculated the size of China's GDP in 2008. Our revisions indicate the need for a 12.9 to 16.0 percent upward restatement of 2008 results, which means RMB 4 to 5 trillion in missing output—$600 to $700 billion at exchange rates prevailing then.

The good news from our recount is that China's economy was already more balanced between services and industry than commonly thought. We reckon 2008 service activity accounted for 44.1 to 45.3 percent of Chinese GDP, versus 44.3 to 45.6 percent for the secondary sector, compared with the official version of 41.8 versus 47.4 percent (the remainder is primary activity, mostly agriculture).

The question now is whether last year's "rebalancing" accomplishment is attributable to structural reform or better accounting. There was a little improvement in accounting. The 2013 GDP base was revised, but only by 3.4 percent. The

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adjustment would have needed to be two to four times that amount if all current national accounting shortcomings were addressed. The choice not to make the full revision last month, despite previous intentions to do so, raises questions about Beijing's motives. Why would authorities prefer to report a smaller economy than modern accounting suggests? Will statisticians use the unreported adjustment to "fluff up" GDP growth results in the difficult years of economic adjustment to come, to hide the full extent of a necessary downturn? None of us can be sure.

Structural reform also deserves some credit. The mix of investment and consumption in the composition of GDP, a key gauge of meaningful adjustment, took a modest step in the right direction. Final consumption expenditure—government and households combined—contributed 51.2 percent of 2014 economic growth, 3 percent higher than 2013. While exports also rebounded to play a big role in delivering 2014 growth, the relative discipline in investment was the foremost story. The People's Bank of China (PBoC) constrained credit expansion enough to permit consumption to rise as a share of GDP. Extrapolating from other data (Beijing has yet to release 2014 gross capital formation figures, which we require to properly estimate investment in GDP), we find that a mere 2.83 percent of China's 7.4 percent headline growth, or 38.3 percent of new economic output above the 2013 base, was from investment growth. That is the lowest share since the first quarter of 2013, and on an annual basis, the lowest since 2000. With state banks crying for easier credit, the PBoC could not have held the credit line as well as they did without support from China's topmost leadership.

Both the industry and expenditure-based pictures of China's economy offer evidence of healthy rebalancing tendencies. However, harder economic adjustment pressures are yet to come. GDP growth in 2015 will be even lower than in 2014, a result of the "new normal" to which President Xi Jinping increasingly points—this is not the trough of a business cycle but the middle of a still-declining range. There are two ways that Beijing could steer toward a 7 percent GDP target this year. As it started to do last year, it can amplify the crowding-in effect among domestic and foreign private investors by intensifying economic reforms and opening space for productivity and growth. But that means less room for authoritarian maneuvering. Alternatively, it can sacrifice the monetary and fiscal moderation that steered down over-investment last year and revert to stimulus to a greater degree to deliver short-term results. This month has seen some of that, but it is not too late for the 2015 balance of policy to emphasize reform. ■

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Simon Says...

There is a joke that goes, "The most miserable life is watching Chinese stocks by day and Chinese soccer at night." The world's most populous nation has always struggled with its soccer team. Ranked #96 worldwide according to FIFA, the Chinese are constantly traumatized by losing games to lower-ranking opponents. After countless attempts to improve technique, however, the country has started to blame its dismal performance on corruption. In the past few years, the Central Commission for Discipline Inspection and the Ministry of Supervision have introduced anti-graft measures in the hope of aiding the underachieving team. China vowed to make player and referee selection "more open", and in this case, transparency worked in China's favor. During this year's Asia Cup, the Chinese national soccer team won its group stage and advanced to the quarterfinal, its best achievement ever since the team entered the World Cup in 2002.

The Discipline Commission cannot wait to share the exaltation. "On top of the techniques, please recognize the significant improvement in the 'environment.' Our anti-graft inspection is the key to the rise of China's soccer," the Discipline Commission commented right after the team's return. The **State Council** has also passed a proposal for further soccer reform, which will also likely be discussed during an upcoming **Central Deepening Reform Leading Group** meeting. Soccer reform will become a part of the thirteenth five-year plan to spur investment to the industry... ■