# China's Enigmatic Slowdown


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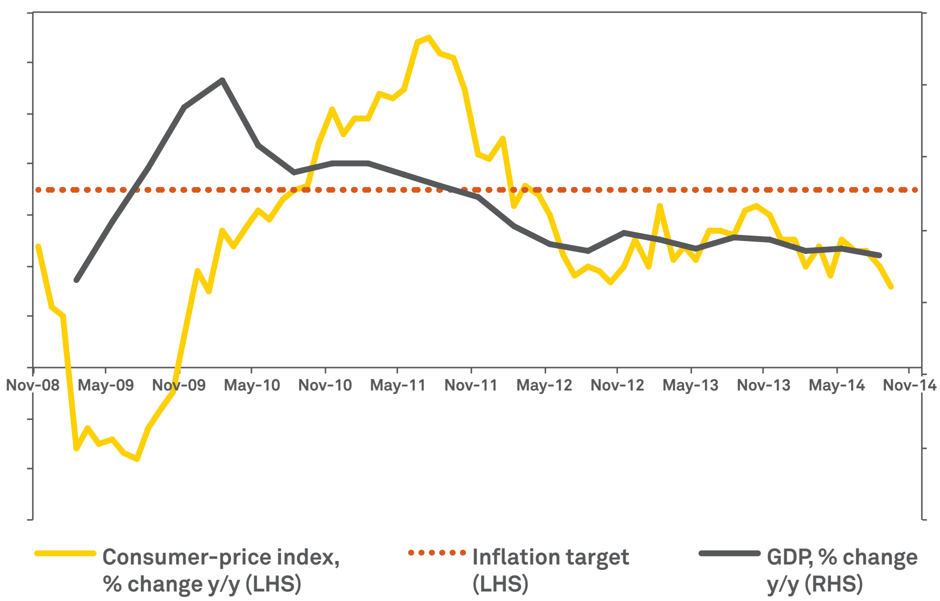
China does not need a 2008-style stimulus, which pushed inflation far above target. But it does need a bigger impetus than it has received thus far.

The chart below shows growth and inflation in an unidentified economy. Even without naming the place, it is clear that all is not going well. The country is no stranger to deflation, having suffered several months of falling prices in 2009. In more recent quarters, it has endured a steady slowdown in economic growth. As a consequence, inflation has remained below the official target for well over two years. Last month price pressures fell sharply again.

**Unidentified Flailing Object**




Source: BNY Mellon, Thomson Reuters Datastream. Last data point: September 2014.

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Most economists looking at this nameless, numberless chart would assume the economy was falling comfortably short of its full potential. Demand must be weaker than supply, they would surmise, weighing on prices. Being a prescriptive bunch, these economists would no doubt call attention to the authorities' failure to meet their own inflation target and wonder loudly if enough was being done to stimulate spending. A responsible economist might recommend restoring growth to something like its late 2011 pace, which, allowing for lags, seems roughly consistent with on-target inflation.

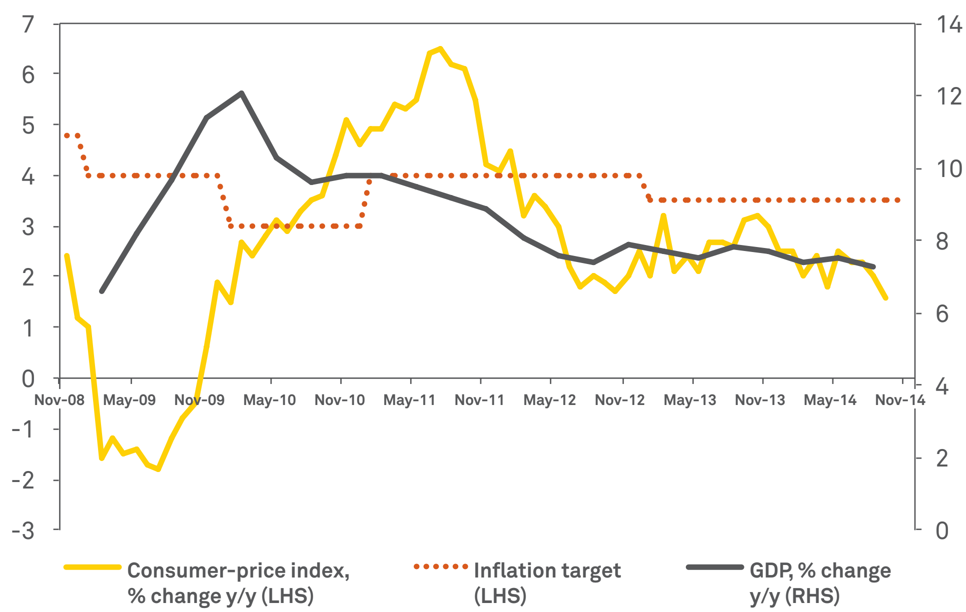
China's growth (which was 7.5% in the year to the second quarter and probably slower than that in the third) seems to be falling short of its sustainable limit.

This reasoning is quite routine. It is the sort of thing economists often say when discussing the euro area, for example, or Japan. But the mystery chart above does not portray either of those economies. It instead depicts China.

The chart below restores the name and the numbers. (It also shows the minor shifts in China's official inflation target, set each year by the State Council, China's cabinet.) Both growth and inflation are of course much higher than is typical of a mature economy. But the underlying economic logic still applies.

China's growth (which was 7.5% in the year to the second quarter and probably slower than that in the third) seems to be falling short of its sustainable limit. As a consequence inflation has remained below the official target for 32 months in a row. In September consumer-price inflation was just 1.6% (compared with the same month a year earlier). The absence of inflationary pressure is even more striking further upstream. Producer prices have been falling (year-on-year) for 31 months. The September figure was -1.8%, according to China's National Bureau of Statistics.

**Lowflation in China**




Source: BNY Mellon, Thomson Reuters Datastream, Chinese Government Work Report.
Last data point: September 2014.

And yet most economists refuse to believe that China's growth is much below its sustainable limit. They complain (rightly) about China's excessive homebuilding and grandiose infrastructure investments. They shake their heads in bafflement at monstrous increases in lending. Most would scoff at the notion that China could grow again at 8%, let alone the even faster pace it enjoyed in late 2011.

For this reason, even as inflation ebbs, many economists are wary of calling for further stimulus. They worry that additional help will unleash lending to parts of the economy that have already borrowed too much, namely property developers, state-owned enterprises, and some local governments, which often raise money indirectly through financing vehicles set up for the purpose.

But extra lending to these groups is not the only kind of stimulus. Indeed, judging by recent experience, it is no kind of stimulus at all. Rapid increases in credit have failed to translate into equally rapid increases in nominal GDP. This is probably because much of the borrowed money was spent on existing assets, such as land and property, that do not add much to production, jobs or consumer-price pressures. If this form of credit expansion packed much of a GDP punch, China would already have rapid growth and high inflation.

The economy's critics are right to argue that China needs to stabilise its high ratio of corporate debt to GDP. But in bringing that ratio under control, the authorities need to take close care of the denominator—nominal GDP—as well as the numerator. Credit restraint will not help if it causes nominal GDP to slow disproportionately. By the same token, credit expansion will not hurt if it causes nominal GDP to grow disproportionately. In achieving the latter, happier outcome, the composition of credit is as important as the quantity. Lending should support the production of new goods, not speculation in existing assets.

Easing does not have to be only of the monetary sort. The fiscal authorities can also help by, for example, cutting taxes and lifting social expenditures. The indebted parts of China's economy will find it easier to curb their borrowing if the rest of the economy increases its spending in counterpoint.

China does not need a 2008-style stimulus, which pushed inflation far above target. But it does need a bigger impetus than it has received thus far. Most economists looking at the nameless chart above would conclude that the economy is failing to make the most of its growth potential. That conclusion should not change just because the word "China" is added to the title.

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