Opacity and pessimism in China

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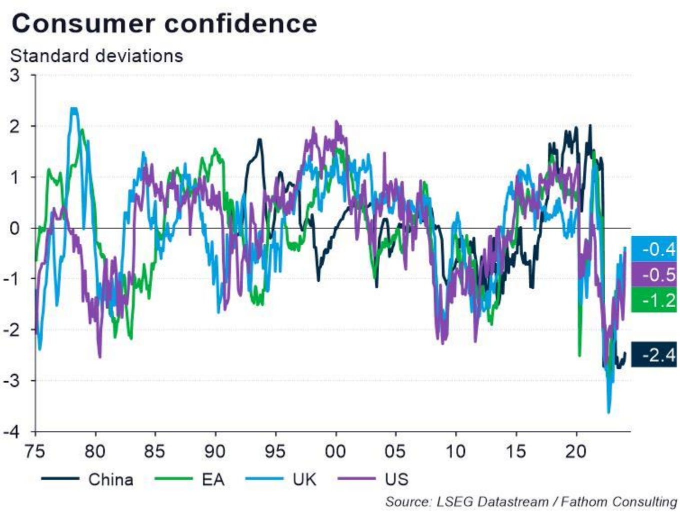
The worst appears to be over, post-COVID. In Fathom's latest *Global Outlook, Spring 2024*, our central scenario argues that although confidence remains lower than usual, it is on the rise across the US, EA and UK, as shown in the chart below. In short, we conclude that things look to be on the up. But there is an exception to that finding. This note explores why China is not joining in with the spreading mood of economic optimism.



Fathom's suite of proprietary indicators offer unique insight into China's economy. They inform our Global Outlook and have led to numerous correct calls in the past: for example, that China had yet to exhaust its supply of cheap labour and as a result was not about to drive up global inflation . That call was controversial at the time we made it, back in 2022, with many analysts focused on China's terrible demographic trends and the impact they would have on the available pool of labour in the so-called 'factory of the world'.

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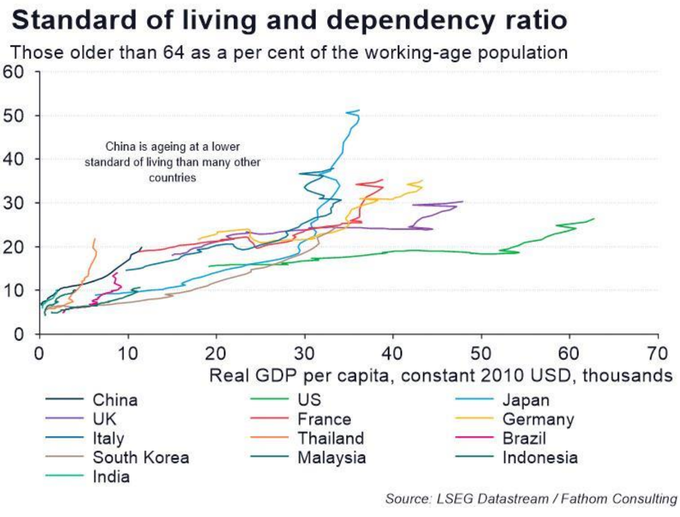
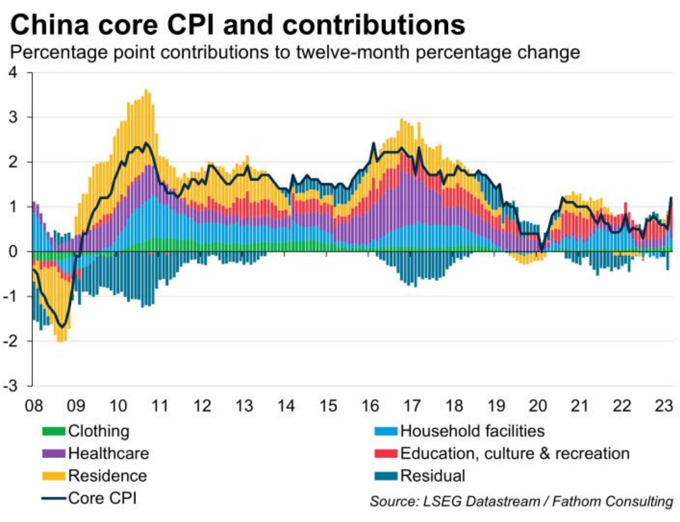


Instead of focusing on where it was easiest — where the light was shining — Fathom's analysis was based on a detailed study of the factors driving China's role in influencing global inflation and it identified vast quantities of underemployed workers in China's labour market, most notably the construction sector, with around a third of those employed in the industry either producing very little or nothing.

Now that the troubles in China's housing industry are clear for all to see, the notion that China will not be a source of global inflationary pressure is much less controversial. Indeed, the Chinese New Year up-tick aside, China's core inflation has been hovering at around 0.5%. Another of Fathom's proprietary indicators[1] reveals that this weakness is due to an increasingly smaller contribution to core inflation from residential property prices.



House prices are failing to rise even though China is no longer adding to its massive oversupply of housing, as shown below. Indeed, the number of housing starts now matches the number of housing completions for the first time in over two decades. By

1 The weights for each of the subcomponents are not made publicly available by China's National Bureau of Statistics, and consequently nor are the percentage point contributions to China's headline and core inflation rates.

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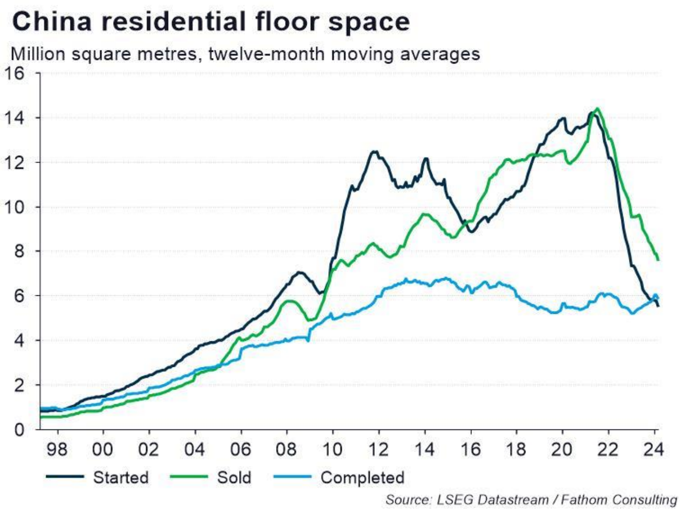
definition, anything started but not completed is either under construction, paused or has been demolished. With the exception of demolitions, this adds to China's spare housing stock. As a consequence, the amount of excess floor space in China is already large enough to house 274 million people — that is the entire population of Indonesia.



Notably, China is eating into that spare capacity, with the amount of floor space sold (the green line) exceeding the amount started. Nevertheless, there is still a profusion of excess capacity that needs to be carefully managed alongside other government priorities, which include:

- propping up the economy, which has for a long time been achieved via investment in housing
- maintaining employment to avoid social unrest, which has contributed to the vast amount of hidden underemployment previously mentioned
- avoiding a collapse in house and land prices, which would weigh on local government coffers since so much of their income is derived from land sales

Past work has identified provinces in the Northeastern regions as facing the toughest juggling act. Interestingly, local governments here look to be up to their old tried-and-tested tricks, holding back supply — as evidenced by falling land sales volumes — in order to support land prices, which are up almost 60% year on year.[2] Overall, this means their revenues are largely unaffected, while helping reduce the problem of oversupply in China's housing sector.

2 If this were a demand-driven collapse in land sales, prices would likely have fallen too.

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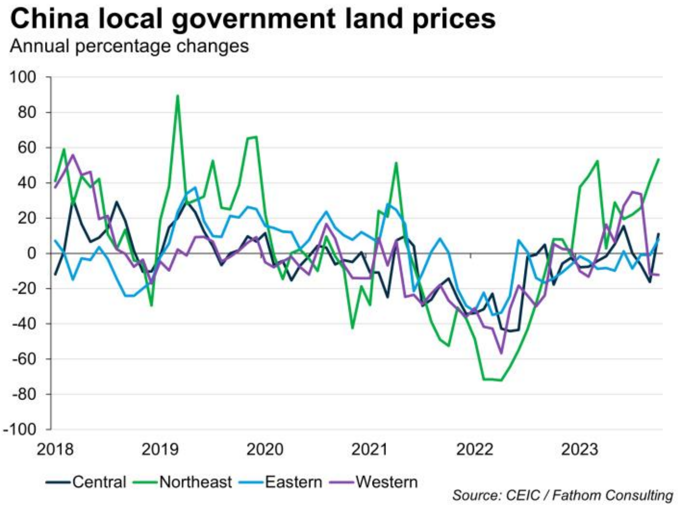
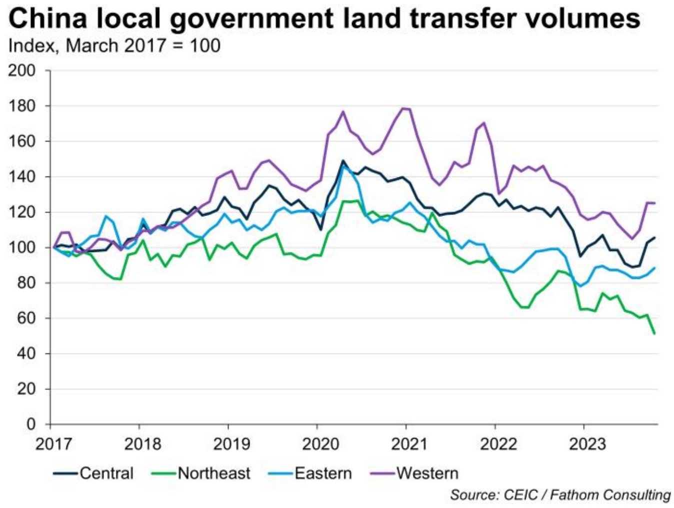
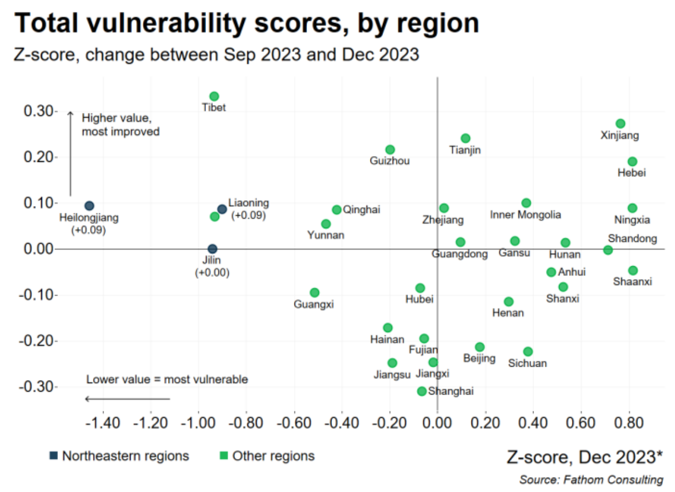




According to our vulnerability score, which combines various metrics such as the house price-to-income ratio, time taken to finish construction and real estate developers' asset-to-liability ratio, it is the most vulnerable provinces that have improved the most in recent months. In other words, there has been some marginal improvement in their imbalances.



The danger is that the juggling act goes wrong; but unpicking to what extent it goes wrong has become an increasingly difficult task. China has discontinued tens of thousands of data series over the past decade, or revised them without backdating. For example, China's youth unemployment rate reached over 20% last year, before the series was discontinued and replaced with a new series that had not been backdated. This new series excludes students, but at 15% is still about three times the overall unemployment rate in China.

This increasing opacity has implications for gauging China's true economic growth rate, a task performed by our China Momentum Indictor (CMI). The chart below examines the possible divergence in China's GDP according to four different metrics: official GDP, a Li Keqiang index, our own China Momentum Indicator (CMI) and an index of Shanghai stock exchange corporate gross value added. The uncertainty around each of these is calibrated according to the uncertainty surrounding the MPC's backcasts of UK GDP, adjusted to account for the fact that China has higher growth and therefore presumably higher uncertainty.

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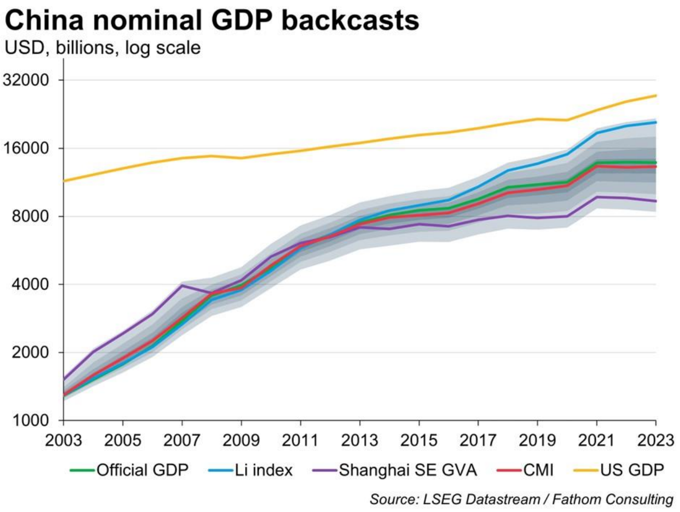
The widening range in the chart suggests that growth and the level of GDP could already be much lower (or, conceivably, higher) than our CMI suggests. The reason for inflating reported GDP is fairly obvious; but why would a country want to under-report its performance? That is where Fathom's 'broken wing' theory comes into play. Like a parent bird drawing predators away from the nest by a show of weakness, China could be attempting to allay the fears of the US and elsewhere by making a show that it poses no economic threat. At the very least, it is now drawing attention to the weaknesses which it once tried to hide.

Distinguishing what is noise from these signals is increasingly hard to do, which emphasises the importance of shadow indicators such as those created by Fathom. **For more information about Fathom's proprietary indicators, tools and models, click here.**



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