How Real is China's GDP?

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Chinese GDP beat expectations in Q3, growing 6.9% y/y—the country's lowest growth rate since 2009. While this figure exceeded the financial media's expectations, it also spawned questions regarding its accuracy, and the reliability of Chinese data in general. Many suspect China's real (inflation-adjusted) GDP may be fabricated. In our view, these concerns seem misplaced. First, GDP reports have never been indisputable, regardless of the country producing them. Moreover, whether China grows around 7% or closer to 5%, it still contributes tremendously to global growth and developed-world firms' revenues.

China's Economic Figures under Scrutiny

China's official economic figures often come under question—partly because of the government's reputation for opacity, and partly because an infamous quote via WikiLeaks from current Premier Li Keqiang which called China's GDP "manmade" and urged observers to use alternate statistics like electricity generation, rail freight and loan growth. That 2010 leak spurred a barrage of speculation surrounding China growth, with analysts weighing in with their own estimates on a quarterly basis. Most overlook, as Anatole Kaletsky recently pointed out at Project Syndicate, that the International Monetary Fund's (IMF) in-house estimates are largely in line with China's official figures.

The disbelief in China's GDP suggests a behavioral error called confirmation bias: people's tendency to latch onto data that support their belief and shun evidence that contradicts them. Kaletsky writes:

"Many Western analysts, especially in financial institutions, treat China's official GDP growth of around 7% as a political fabrication – and the IMF's latest confirmation of its 6.8% estimate is unlikely to convince them. They point to steel, coal, and construction statistics, which really are collapsing in several Chinese regions, and to exports, which are growing much less than in the past."

Developed Firms Confirm No Hard Landing in Sight

This does reveal the contradiction in skeptics accepting the truth of dismal government figures for construction and steel output – down 15% and 4%, respectively, in the year to August – and then dismissing official data showing 10.8% retail-sales growth. Furthermore, disbelieving pundits could very easily consult commentary from developed firms actually doing business there. We have, and their commentary does not suggest a marked slowdown is in the offing. What follows are a few quotes from executives from such firms:

"I get updates on our performance in China every day, including this morning, and I can tell you that we have continued to experience strong growth for our business in China through July and August…I continue to believe that China represents an unprecedented opportunity over the long term." - Tim Cook, Chief Executive Officer, Apple Inc.

"Finally, in greater China, revenue was up an amazing 30%, tremendous growth that again proves more than ever the success of our strategies." - Trevor A. Edwards, President-Brand, Nike

"What we see is that many people in China appreciate the IKEA offer and we are making it more accessible to them through new stores. And the middle class will continue to grow, I'm pretty confident about that, so we have a positive view on China." - Peter Agnefjall, Chief Executive Officer, IKEA

"Häagen-Dazs ice cream posted low-single-digit net sales growth in China, led by good performance on our retail products. And I'm pleased to report that our Yoplait yogurt launch in Shanghai is off to a good start. We've already achieved a 5% value share of the yogurt category in that city." - Kendall J. Powell, Chairman & Chief Executive Officer, General Mills, Inc.

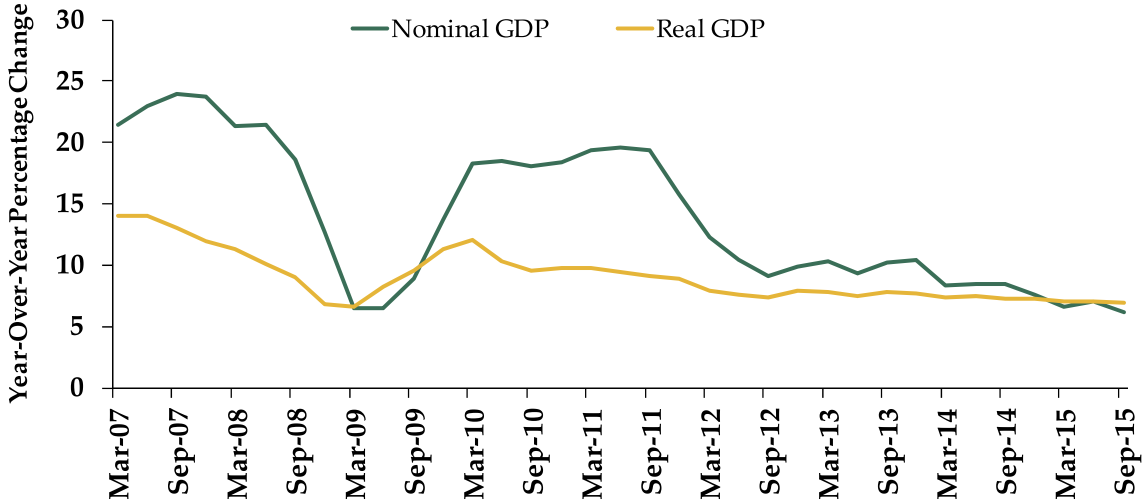
"Our China business grew 6% with every one of our 14 brands there posting gains. We now have a presence in nearly 100 cities, having added 18 new cities during the year. We continue to expand our digital presence in China, further penetrating the largest market for e-commerce in the world." - Fabrizio Freda, President, Chief Executive Officer & Director, Estée Lauder

Adjustments to GDP

No GDP report anywhere in the world is perfectly accurate. It is simply impossible to record every last dollar spent. US GDP for example, misses most of the so-called "sharing economy," informal transactions (like cash payments for some services), and many freelancers and self-employed persons. For example, kitchen-table entrepreneurs sold about $2 billion on Etsy last year, and GDP caught none of it. GDP is also subject to a fair amount of scrubbing from seasonal and inflation adjustments. Several years' worth of GDP was recently revised to fix some seasonal adjustment errors that understated wintertime growth. Moreover, sometimes GDP is revised decades after the fact as statisticians change their minds about what should and shouldn't be included.

In China's case, most of the scrubbing comes from the inflation adjustment. Most agree China's nominal GDP figures are reliable, but they believe the "real" figures look a little too steady (Exhibit 1).

Exhibit 1: Chinese GDP Growth



Source: FactSet, as of 10/19/2015. Year-over-year change in nominal and real GDP, Q1 2007 – Q3 2015.

Q3's figures attracted extra scrutiny because real GDP exceeded nominal GDP, which grew just 6.2% (the lowest in 25 years). When real GDP exceeds nominal GDP, it means statisticians adjusted for deflation, which many consider odd since China's consumer inflation was positive all quarter, ranging from 1.6% to 2.0% y/y. But producers' prices plunged more than -5% y/y all quarter, and the adjustments are supposed to account for price changes at all levels of the supply chain, so this is not surprising. In dissecting sector-level GDP, only heavy industry got a bump up from the deflation/inflation adjustment. Agriculture and services were adjusted downward, which all seems fairly consistent with the divergence between consumer and producer prices.

Nor is it unusual for inflation adjustments to over- or under-state growth in general. Several prominent economists believe the US's GDP deflator has overstated inflation for decades, failing to appreciate how technology has improved the overall value of goods and services. As Martin Feldstein wrote in The Wall Street Journal in May 2015, if a hospital stay is more expensive today, but the treatment is far more robust and effective, is it fair to look only at the nominal price increase? In China's case, statisticians are trying to track prices and development across a gigantic country with over 1 billion people, a rapidly developing service sector and a large informal sector. In our view, it would be more shocking if the inflation adjustments were not vague.

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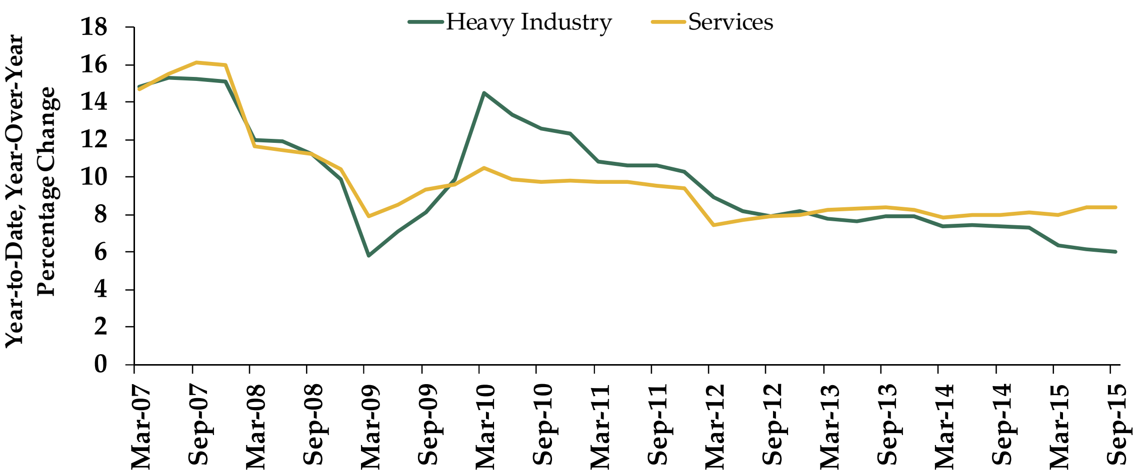
China's Shift to Consumption-Led Growth

Viewing China's growth at a sector level offers an alternate, perhaps more illuminating perspective. As Exhibit 2 shows, service sector growth eclipsed heavy industry in Q1 2013 and has maintained leadership since. Through Q3, the service sector grew 8.4% year-to-date from 2014's first three quarters, compared to just 6.0% for heavy industry. This is yet another strong indication that China's slowdown stems from the ongoing shift away from investment, construction and factories to consumption and services, a point President Xi Jinping underscored after the GDP release. Slower growth is a function of economic reform, not a sign of fundamental weakness, and the widely feared hard landing remains as unlikely as ever.

Exhibit 2: Sector-Level Chinese Growth



Source: FactSet, as of 10/19/2015. Year-over-year growth in the year-to-date value added of the China's secondary (heavy industry) and tertiary (services) industries, Q1 2007 – Q3 2015.

Some fret China's services-led growth will not support the global economy as much as factory-led growth did, but that seems overstated. Yes, China's pure service markets (e.g., health care, financial services) are fairly closed to foreign competition, but foreign firms have a huge presence in China's retail sector, and China is striving for a US-style consumption-driven economy[1]. The more consumers ascend in China, the more demand there will be for various products from the developed world. The specific foreign sectors that benefit from China's growth might evolve, but there should still be a large net positive.

Overall, our view on China remains the same: Investors remain too dour, and reality likely continues beating expectations. That should boost equities, which have priced in the slowdown for years now. Even modestly slower Chinese growth should remain a significant positive for the global economy and markets.

1. Service-led and consumption-led growth are not mutually exclusive, and there is actually a lot of overlap. There are simply two main ways of breaking down GDP: output-based and expenditure-based. Output-based GDP tallies the value added from agriculture, heavy industry and services. Expenditure-based GDP tallies all spending and investment from households, businesses and the government, along with net trade.