Worsening economic data coming out of China

Nick Beams
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The economic news coming out of China is all pointing one way—downwards.

On Sunday, the National Bureau of Statistics reported that the official purchasing managers' index (PMI) for manufacturing dropped to 49.2 in October, the second straight month in which this key index for factory activity has fallen.

With 50 marking the boundary between contraction and expansion, the October reading was lower than the 49.6 recorded for September and was the lowest since the start of the COVID-19 pandemic in February last year. The figure was well below the 49.9 median forecast of economists polled by the *Wall Street Journal*.

The main factors in the lower result were rapidly rising raw material costs, a widespread power shortage and a sharp slowdown in the real estate sector. The property giant Evergrande continues to struggle to avoid bankruptcy and is leading a hand-to-mouth existence as it seeks to make interest payments on dollar-denominated debt.

Before the falls in the last two months, China's manufacturing sector had enjoyed something of a boom as it recovered from the effects of the pandemic.

According to the *Wall Street Journal*, while some economists had expected factory output would improve as power curbs imposed last month eased, the PMI readings suggest that "the broader picture for China's economy is deteriorating."

"Domestic demand, in particular remains weak, held back by an ailing property market under pressure from Beijing's tightening rules [the so-called three lines that have restricted credit] as well as widespread power shortages and sporadic virus outbreaks that have halted consumption and production activity."

The lower PMI figures come on top of national accounts data which showed that in the third quarter the annual rate of growth had fallen to 4.9 percent—the lowest level in a year, with the economy expanding by just 0.2 percent over the previous three months.

The *Financial Times* reported that pressure is growing on Beijing to loosen the credit restrictions that have been blamed for the mounting problems in the property sector.

It cited a note from analysts at Gavekal Dragonomics who maintain that the source of the slowdown is not on the supply side, such as power shortages and lockdowns. Rather, "the real problem is on the demand side" leading to the transition from an expected slowdown to a "shocking loss of economic momentum."

They pointed to the loss of demand because of the troubles in the real estate sector. "Since the property sector is the most important driver of cyclical activity, overall growth will weaken further [in the fourth quarter] and into 2022," they wrote.

The contraction is evident in other areas. While the non-manufacturing PMI was 52.4, indicating an expansion, it was down from 53.2 the month before.

Citi analysts have warned that weaker manufacturing activity is being accompanied by rising prices and features of stagflation—lower economic output combined with rising prices—that have "become more evident and would limit near-term policy options."

In the middle of last month, as the debt problems of Evergrande continued to mount, the People's Bank of China (PBoC) issued a statement that the financial fallout would be able to be contained and risks were "controllable."

That may still be the case so far as banks and other financial institutions are concerned. But a comment in Bloomberg yesterday drew attention to the fact that banking and finance are not only areas of the economy to be affected by the crisis.

"The key to managing the crisis is not just to contain the risk of financial loans, but also the other two-thirds of the liabilities owed by the distressed real estate developer to a vast network of companies and enterprises in its supply chain—including providers of construction services and material as well as contractors and subcontractors supplying needs raging from labour to decoration."

China, it said, had the world's most complete supply chain because of its vast manufacturing range but this came with the risk that "the sudden collapse of a large non-financial company could cause cascading effects for the real economy at a scale unseen in any other part of the world."

Evergrande did not just borrow from the banks and other financial bodies. In the common practice of many large corporations around the world, it borrowed from its suppliers and contractors by forcing them to accept longer payment terms. When a payment falls due, the smaller companies are asked to accept commercial bills instead of cash—in effect a further extension of payment—which they can then sell to brokers at a discount.

This had the potential to cause a large group of suppliers and contractors to not only lose business but to experience financial distress "possibly creating a chain of bankruptcies upstream," the Bloomberg article said.

It noted this situation was "new territory" for China's central bank, the PBoC. While it had a good record of rescuing financial institutions that had failed, "the restructuring of a large non-financial institution with liabilities on the same scale as Evergrande is unprecedented."

The crisis is by no means confined to Evergrande. According to a report by the research firm China Real Estate Information Corp. (CRIC) released yesterday, new home sales for the country's top 100 developers fell by 32 percent in October. The CRIC report said that the outlook for the property market did not look promising and sales could continue to slow for the rest of the year.

In another report on the debt crisis facing many developers, Bloomberg said the key question was becoming "who will survive in China's property sector" as the country's credit market "undergoes its biggest shakeout in years."

In the past, offshore borrowing arranged through Hong Kong has been a means by which cash-strapped companies have been able to raise funds. But with junk bond yields reaching as high as 20 percent it has become "all but impossible for stressed developers to refinance their maturing debt."

According to Bloomberg calculations, Chinese developers have more than $2 billion of onshore and dollar-denominated payments due in November. It reported that at least four building companies defaulted last month while Evergrande twice averted being declared in default only by making interest payments at the last moment. But it is living from day-to-day with the 30-day grace period on another $148 million of interest payments ending this month.