Purchaser Managers' Index (PMI) in China and the outlook of economy

Ahmet Goncu
Xi'an Jiaotong-Liverpool University
Suzhou, 215123, China
goncuahm@gmail.com

1. Introduction

In this section we will overview some of the recent developments in Chinese financial markets before getting into details of the foreign trade and its effect on the Chinese economy. S&P removed for the first time the triple-A rating of the U.S. has held for 70 years. Probably, the downgrade of US treasury bonds credit rating by S&P was the most important development in August for the financial markets, which also had important effects on China. Following the downgrade announcement Shanghai Composite index (SSE) dropped about 3% in the next trading day. However, the index has been performing poorly during 2011 due to the increasing inflation and negative outlook in the USA and European economies. The main concern for the Chinese economy is inflation and possibility of a 'hard landing'.

The economic situation in US and Europe is still very fragile. In August PBC did not resort to any additional measures to fight against inflation. The strategy now is largely dependent on the developments in the US and European economies. If the outlook in major economies does not deteriorate further, PBC can continue to put the priority to control inflation. For example, in case of a double dip in US economy, probably the attention of PBC will be on avoiding any hard landing in the Chinese economy. A hard landing would create far more problems than high levels of inflation for the Chinese economy due to the risk exposure in property market. A hard landing would start a slump in property prices.

In August, People's Bank of China (PBC) announced the CPI rate for July to be 6.5%, which was slightly higher than expected. However, markets are still expecting the inflation to slow down relatively in the coming months.

In our last report we discussed the policy options of PBC to tame inflation. After the new record high July CPI level PBC did not resort to any additional measures. As we discussed before, interest rates and required reserve ratios are already quite high. Required reserve ratio is still at 21.5% level, whereas the one year benchmark lending rate is sill at the 6.56% level. Just after the downgrade of US treasuries the global markets' sentiment turned negative and this reduced the incentives for the PBC to increase interest rates further. Now, in terms of interest rates the PBC will choose to respond based on the global economic outlook and inflation in China in the coming months. A large increase in interest rates should not be expected since this can put too much pressure on the appreciation of the RMB and further inflow of capital to property market. PBC during the last month continued to let RMB appreciate towards 6.39 levels (see Fig. 1), and any further large interest rate hikes would let RMB appreciation pressure to increase. As known, export industries do not have the profit margins to cope with sudden appreciation of the RMB. Therefore, if inflation does not slow down in terms of the interest rate and reserve requirements, PBC policy tools are very limited to a few further interest rate or reserve ratio hikes. However, fiscal policies and other heterodox price control measures are still being implemented by the government.

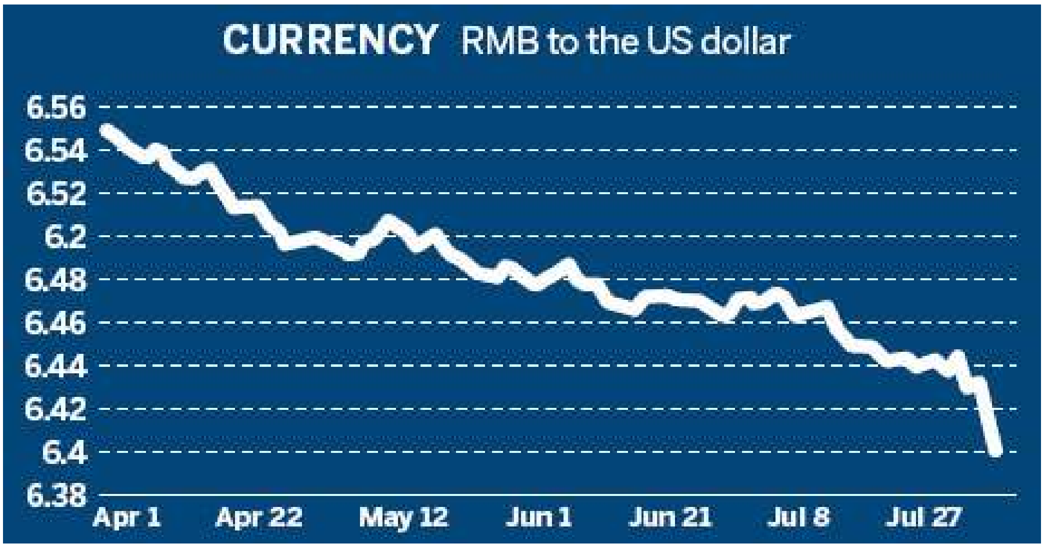

Figure 1. US Dollar/RMB

Another issue is the nature or driving force of inflation in China. The monetary base expanded in China and loose monetary and fiscal policies during the stimulus program can be held as the main source of inflation today. However, it should be noted that commodity and food prices is also contributing to the increase in inflation. For example; food prices in 2011 soared in double digits around 15% compared to last year. The price increase in pork prices in July was over 50%. Government responded to this situation by selling some of its strategic food reserves. These are just some of the examples showing that actually effects of inflation are much more severe for low income class in China. International commodity and food prices in turn are closely related to the US dollar and its stability. Any further quantitative easing by FED (Q3) is a major risk for PBC. Expansionary monetary policies by FED will put PBC in a dilemma either letting RMB to appreciate even faster to control inflation rather than importing inflation or focusing on avoiding any hard landing and at least for a temporary period of time ignoring high inflation.

2. Purchasing Managers' Index (PMI)

In this section we discuss the recent developments in the Chinese PMI and its relation to the economic outlook of China. PMI is an important economic indicator; however it should be interpreted with care since it does not give a perfect picture on the direction of the economy as a whole.

China produces three separate PMI indices - one semi-official (from the National Bureau of Statistics) and two private (from HSBC; and from Market News International, a Xinhua Finance company).

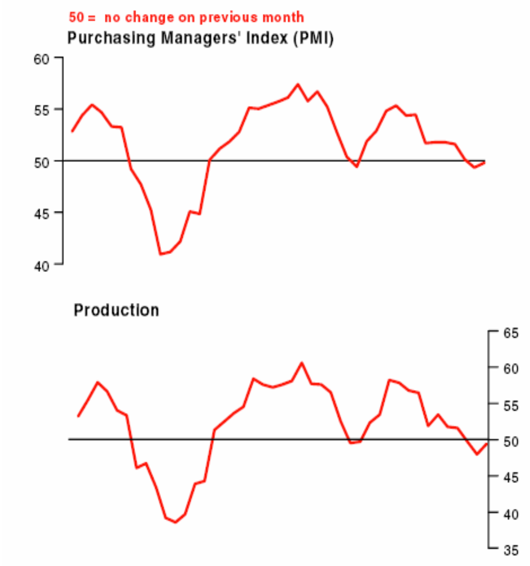

Figure 2. PMI and Production Index for 2011

Indicatively, the semi-official NBS PMI is weighted heavily in favor of large state-owned enterprises across industries and sectors, whereas the HSBC PMI gets the measure of private multinational industries. Although the three PMI indices have a correlation with each other, their correlation with GDP data is somewhat askew, characterized by variable lags and a general inaccuracy in picking turning points. In particular, the problem with China's PMI data arises from "seasonality issues" — specific calendar-related effects, such as a sharp pick-up in retail sales before Christmas.

In this report we take a look at the only truly private PMI index released by HSBC. The HSBC China Manufacturing Purchasing Managers' Index (PMI[1]) is published on a monthly basis approximately one week before final PMI data. This index is earliest available indicator of manufacturing sector operating conditions in China.

China Manufacturing PMI was at 49.3 in July, which is a two month high, whereas the **Manufacturing Output Index was at 49.4**. An index value of 50.0 indicating no change on previous month (seasonally adjusted). Below 50.0 suggests a contraction. However, we should note that the above figure is based on HSBC PMI index, which only includes private enterprises but not state owned enterprises.

Compared to previous month it can be seen in Fig. 2 that the PMI index picked up slightly close to the break even point of 50.0. On the exports side, despite the global financial turmoil the new export orders index rose as well, albeit still slightly below 50.0.

From the Central Bank's point of view PMI data is only one of the several indicators about the direction of the economy and no special attention is attributed for the case of China. The reason is simply due to the small sample the index is based on and the askew nature of PMI relative to the GDP growth rates in China. Even with a PMI index below 50.0, which indicates a contraction, GDP might well grow at high levels. This type of situation would not be uncommon in China. Furthermore, PMI focuses on certain industries with a small sample size, which reduces its effectiveness to give a projection on the whole Chinese economy.

[1] HSBC Flash China Manufacturing PMI, source 'Markit'. Data collected 12-19 August.

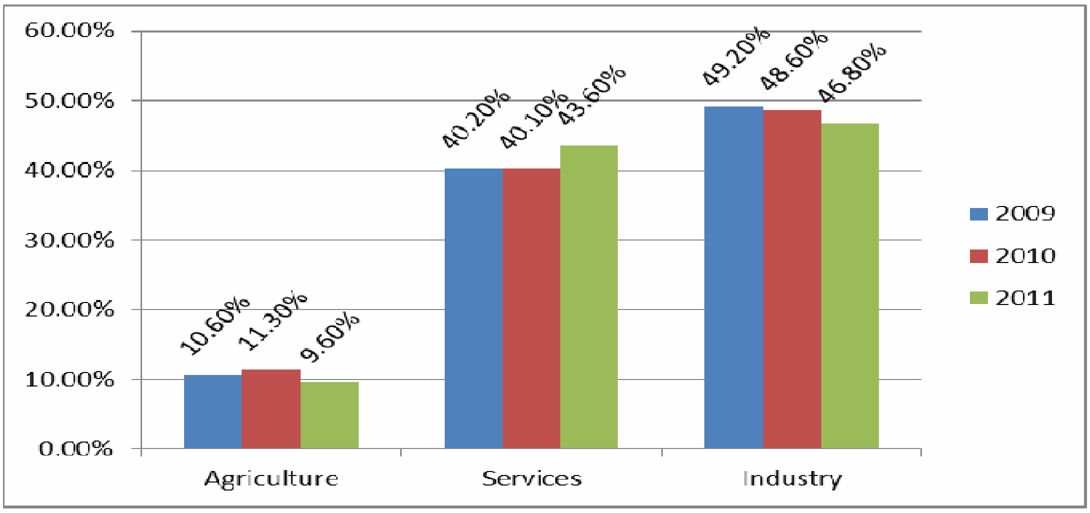

Figure3. GDP composition of China

Private enterprises in which the PMI index is based on do not give an idea about the situation and the growth of state-owned enterprises. In fact the system in China favors large state-owned enterprises. In terms of tax purposes they are treated equally; however access to cheap capital and provincial government support are some of the benefits large state-owned enterprises enjoy. Also, it should be noted that since local governments also own some of the state-owned enterprises, any success of these companies also means appraisal of local governors. This in turn means these enterprises have unfair advantages in many ways against private enterprises.

In Figure 3, the composition of GDP in China is given for the last three years. As announced by the People's Congress in China, state is aiming to increase the weight of the services industry in China's GDP composition. In the recent years, service industry in China is also growing strongly and increasing its share in the whole GDP composition. Manufacturing and export industries are going to be contracting in China, which is natural since there is a transition towards reducing low-tech production and building up of high-tech production capacity. This transition will bring further challenges for China, which we do not get into details in this report. However, the shortage of labor supply in southern export centers of China such as Guangdong province are the early signs that wage increase in the manufacturing industries are not enough to promote further migration from rural areas.

The recent values of PMI, by taking into account that it only describes part of the story, indicates that even after the recent turmoil in global financial markets, the likelihood of a hard landing in Chinese economy is not high for the moment. A slowdown in growth seems inevitable with current conditions, which is already being priced in the equity markets. Shanghai composite index is already at its lowest levels for 2011. Early January 2011, index was above 2800 levels, as of August 30th it is now around 2560 level. Equity markets already priced the downgrade of US treasuries and lower levels of growth in the Chinese economy. However, there are further international and domestic potential risks that might affect the Chinese economy. In the coming months we will see whether these potential risks will be realized or not.

3. Conclusion

August was a month with very high volatility in global financial markets and China was no exception. Given the current conditions and risky financial environment we can expect the volatility will remain high for the coming months. In particular, inflation might remain high due to increasing domestic demand and still not very tight fiscal policies by the central and local government, and lagging response from supply side to match demand. We analyzed PMI and its relation to the economic outlook in China. PMI will give us an early indicator about the direction of the manufacturing and export industries. August values of PMI shows a slight increase in the index, hence coming months will be critical in determining whether this trend will continue and index will go above the break even point of 50.0. Markets will also closely follow September PMI and other economic indicators. Overall, in the short run we expect the financial markets in China to be highly volatile and probably further downward movements in the Shanghai and Shenzhen equity markets are likely. Inflation will show resistance and we still believe that soft landing in the Chinese economy is more likely for the given conditions.