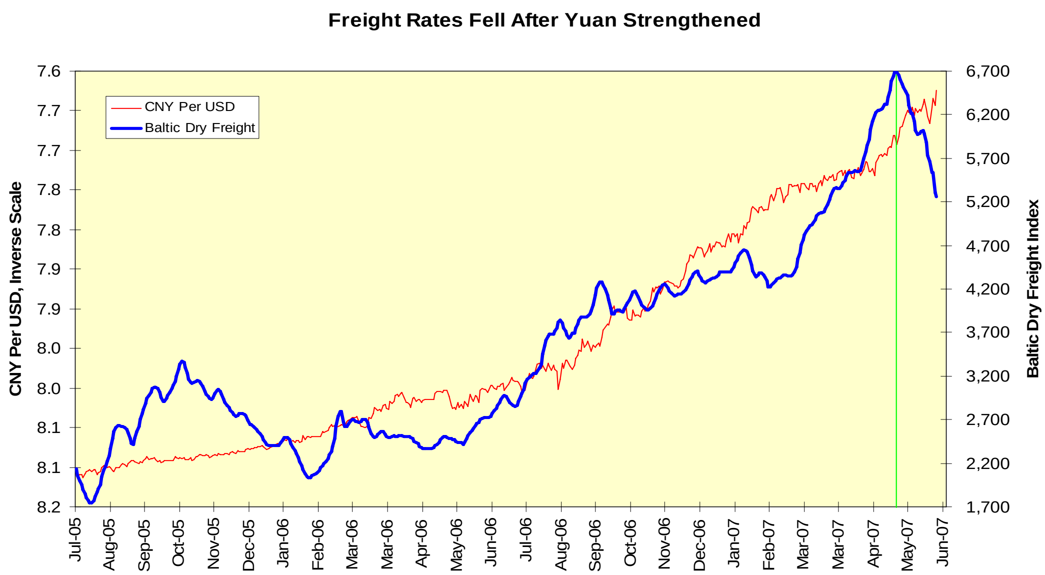
Is China Slowing?

While we all know trees do not grow to the sky, we always act as if this time may be different. So it is with Chinese economic growth; real GDP has grown (by official figures at least) at double-digit rates since the start of 2006. And that side-remark about official figures may be wrong in the unexpected direction; some observers believe the official data have been *understating* real growth.

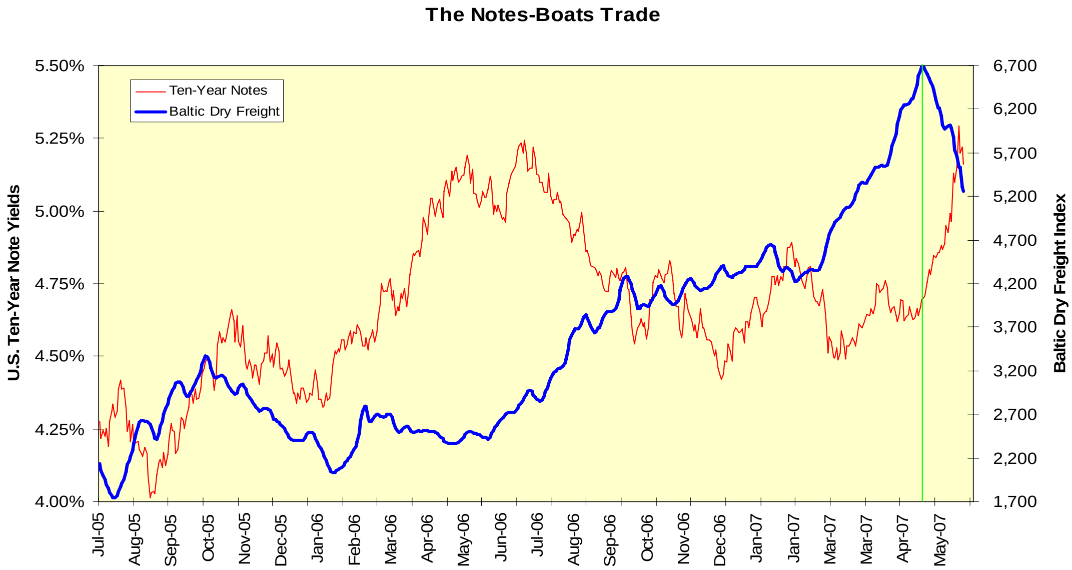
Shipping Is Slipping

Let's resurrect what used to be an old favorite around these parts, one absent since January 2005, the Baltic Dry Freight index (BDIY). I stopped using this as a macro indicator around that time as shipbuilders responded to price signals and began adding vessels to carry ores, grain, coal, cement and other bulk cargo. Had we interpreted the 54.9% decline in the BDIY between December 2004 and August 2005 as a negative macroeconomic signal, we would have been completely and utterly incorrect.

What about now? The BDIY has fallen 21.4% since May 15, 2007. Is this just another isolated instance, or is something else happening. The betting here is something else, and that something else is China's acquiescence to a stronger yuan announced on May 18 and marked on the chart below.



And as they say on the late-night television ads, "but wait, there's more." Let's superimpose the chart of U.S. ten-year note yields against the BDIY. These yields began their ascent to their recent spike high of 5.293% on June 12 from a level of 4.702% on May 15.



All of this may be coincidental, of course, but I doubt it. First, a stronger yuan imposes both a fiscal stress on China and all else held equal raises the cost of Chinese imports in the U.S. This combination is a negative for prospective raw material demands in China and therefore puts downward pressure on freight rates.

Second, and more subtle, is the transmission mechanism between the yuan and its cross-rate against the Japanese yen to U.S. yields; this mechanism was discussed in April 2006. Briefly, so long as the yen remains weak against the yuan, the Japanese do not feel compelled to engage in the yen carry trade themselves by creating yen and swapping them for U.S. Treasuries. The recent strong appreciation of the yuan, up 0.59% since May 18, is doing Japan's work for it in this regard.

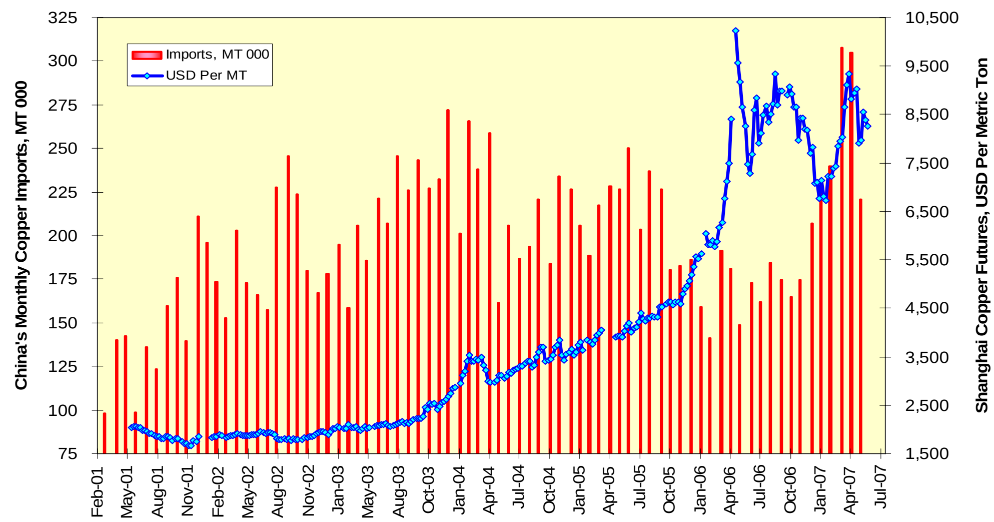
Third, higher long-term interest rates in the U.S. should reduced U.S. demand for Chinese goods. While there is always hyperventilation about what the Federal Reserve's next move on short-term rates will be, it is long-term rates that drive investment.

Finally, U.S. pressure on China to revalue the yuan has increased levels of volatility in financial markets worldwide. As volatility, the price of insuring market outcomes, increases, risk-acceptance decreases. That reduces macro activity.

Copper Going Down To The Wire

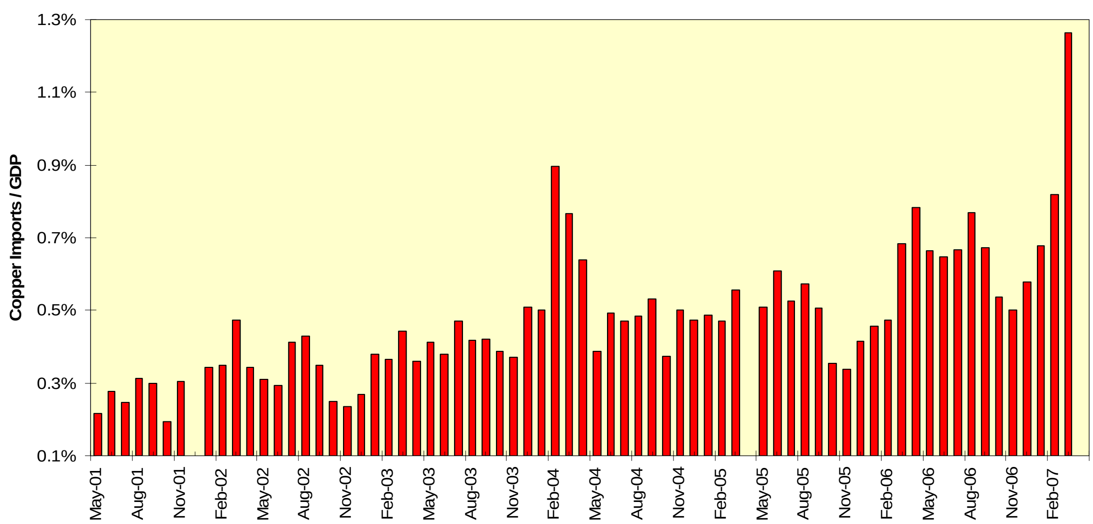
The BDIY is a global index reflecting developments outside of China. Are there related China-specific indicators we can use? Let's take copper, always a good indicator of construction and manufacturing demand. China's imports surged into April 2007, and have fallen swiftly since. In addition, the prices of copper futures on the Shanghai exchange converted into dollars per metric ton have retreated as well. As the world has not come into a windfall of copper supplies in the last two months, let's chalk these developments up to declines in Chinese demand.

China's Imports And Copper Prices



Once again, simple economics prevails. If we calculate the percentage of China's GDP claimed by imports of copper, we see a surge going into the last datum available, March 2007 (I interpolated the quarterly GDP data into monthly data using a cubic spline; thanks for asking). We had every reason to expect such an effect from rising copper prices.

China's Copper Imports As Percent Of GDP



We see similar effects in the prices of other base metals. The price of nickel has fallen close to 20% over the period in question, and the prices of all the other base metals except lead have declined as well. Granted there are other users of base metals in the world besides China, but their demands have dominated the metals markets over the past decade.

Good Or Bad?

If China's deceleration does not deteriorate into something worse – and any cursory examination of economic history indicates this is hardly a given – it is probably a net benefit. Not only will it provide some measure of relief for stressed commodities markets, it will preclude the world's central banks from excessive tightening of credit.

How could it end badly? Well, look at the Japanese experience. We bullied them into allowing the yen to strengthen in the late 1980s and the higher interest rates and tighter credit involved burst Japan's twin real estate and stock bubbles. The nation has yet to recover.

Each cycle and each country are different, of course. The world managed to withstand Japan's collapse, and indeed we can argue their efforts to revive via excess credit have financed the world's asset markets since 1995 at least.

And the nineteenth century withstood crashes every twenty years or so in the greatest emerging market of its day, the U.S., without cataclysm. The Asian financial crisis began on July 2, 1997, almost ten years ago, and while there were some scary moments, we managed to survive.

Let's accept the fact China will have a crisis one day. It is inevitable, really. The present slowdown postulated here is not the same thing as a crisis; only official mishandling can produce one of those.