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Five Reasons to Expect a Muted Recovery in Global Capex

Investment has been unusually weak in this economic recovery—with good reason. We think the capex recovery will be modest and patchy; it is unlikely to drive a sharp rebound in the world economy

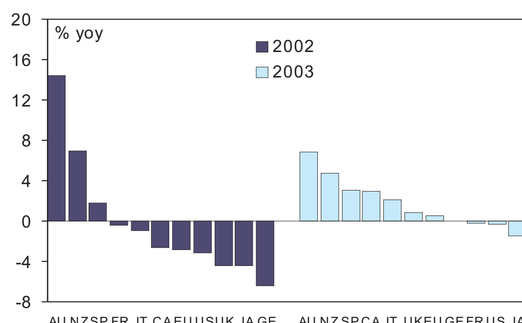
Amid continuing signs that consumers are under pressure, hopes of a vigorous pickup in global capital spending have assumed center stage. Investment has been unusually weak in this recovery, a legacy of the excesses built up in the bubble period and the continued tightness in financial conditions. In 2002, investment fell in the G7 for the first time since 1991. Despite the focus on US excesses, the bust has been as bad elsewhere.

Optimists argue that this period of investment weakness may be nearing an end. They say that excess capacity has been worked off, cash flows are improving, and balance sheet repair is well advanced; all that is weighing on the capex outlook is uncertainty and risk aversion. Once geopolitical risks subside, the stage will be set for a sharp rebound.

We disagree. There are good reasons why investment spending has been weak. Equity markets have been much weaker than normal in a recovery; the scope for a consumer rebound is more limited than in the past; and financial conditions are more restrictive.

Conditions are certainly better than a year or two ago. Dependence on external financing has fallen, profits are stabilizing, and the overinvestment in tech hardware has been largely worked off. All of this supports our view that investment spending will stabilize this year and recover further in 2004. The recovery we are forecasting, though, is weak relative to history and to the consensus view.

GS Fixed Investment Forecasts



We see five problems with the optimistic view:

1. Low Capacity Utilization

Despite significant investment cutbacks, capacity utilization remains at low levels, particularly in the US. This suggests that the need for additional capacity is limited. If you are not even using existing capital fully, the marginal return on investing in new capital is likely to be low.

Capacity utilization rates are often dismissed on the grounds that they usually pick up alongside—not ahead of—investment spending. This is generally true, but only because past recoveries have usually started with a period of very rapid industrial demand growth. We do not expect to see this sort of rapid pickup in demand this time.

Even with no growth in capacity in the US, our projected industrial demand growth of 5% would still not push the utilization rate above its long-term average of around 80% until November 2004. The picture does seem a little better elsewhere. In continental Europe and Japan, capacity utilization is closer to its longer-term averages (the UK looks more like the US), and above-trend growth might lead to a quicker pickup in capital spending.

2. Little Scope for Demand Acceleration

A sharp acceleration in household spending growth has led most business capex recoveries in the G3 by a quarter or so. But prospects for above-trend growth this time are weaker than normal. Consumer spending growth has remained high, meaning that consumers in many countries have already 'used up' the demand that typically accumulates during slowdowns.

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Five Reasons to Expect a Muted Recovery in Global Capex

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We expect G7 consumer spending to slow this year and to remain below-trend until the end of 2004. With none of the major economies well placed to boost private spending, exports are also unlikely to provide a major lift.

3. Weak Stock Markets Indicate Lower Expected Returns

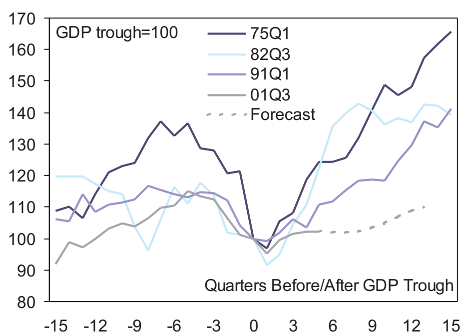
The continued weakness in stock markets is unprecedented in post-war recoveries. Most previous investment recoveries in the G3 (not just in the US) have been preceded by a significant rise in the equity market. While low rates of capacity utilization suggest that the current expected return on investment is low, the weak stock market suggests that expectations of *future* returns have also fallen significantly. This is a key factor in our expectation that this investment cycle may be unusually weak.

4. Modest Profit Recovery and Tight Financing

Cash flow has a reasonably good relationship with investment spending, and sharp profit rebounds have often presaged higher investment. Recent signs of recovery in profits and cash flow have accordingly fuelled optimism about a capex recovery.

We remain cautious, for two reasons. First, if there is little appetite for new capacity, incremental cash flow may not feed directly into higher spending. Second, the profit outlook still looks soft. Margins have stabilized in the US, but at a low level, and the outlook is poor. We expect cash flow to grow by less than 5% in most countries in 2003 and 2004.

US Fixed Investment Through Recessions



External financing is also unlikely to provide a meaningful boost. While the cost of capital has fallen, credit spreads remain historically high for this stage of the cycle. Credit conditions are tight not only in the US, but also in Germany and Japan—where the banking system is both a greater source of intermediation and in a more fragile state.

5. Ongoing Balance Sheet Repair

Corporates have made significant progress in reducing the substantial financial deficit (negative cash flow) accumulated during the boom years. The US corporate sector has reduced its deficit from a peak of around 4% of GDP to 0.8%; there has been an even larger adjustment in the UK and a milder improvement in Europe and Japan, where financial positions were never as stretched.

But we think the financial adjustment may not be over, at least in the US:

- The correction follows an unusually extended period of corporate borrowing. Countries that have been through similar corporate excesses (the UK and Australia in the late 1980s, Japan in the early 1990s) have seen the repair process last four years or more.

- There is nothing magical about the 'zero' level. In past US recessions, the corporate sector has ultimately brought its financial position back into surplus. Elsewhere, financial positions have swung by more than 10% of GDP.

- Although corporates have reduced their ongoing financing needs, leverage has not fallen. Expected asset returns have fallen, corporate spreads remain high, and macroeconomic uncertainty has risen. This all suggests that optimal leverage is lower than in the late 1990s.

Faced with weak equity markets and expensive debt, corporates may choose to pay down debt rather than invest in new capital.

The Gloom Is Not Uniform

Not all of the constraints we identify are relevant for all sectors. Telecoms and aircraft are still working off capacity overhang; utilities and natural gas have financial constraints; autos and durable goods face uncertainty over the sustainability of demand growth. It is hard, however, to point to major areas that have the incentive, capacity and financing to expand investment aggressively.

The same is true geographically. Capacity utilization may be a smaller issue in Japan and Europe than in the US, but credit restraint is higher and demand growth weaker. The backdrop to decent investment growth is likely to be strong domestic spending growth, easy financial conditions, resilient equity markets and a sharp profit recovery. Envisaging those conditions in many large economies is still quite difficult.

The most promising candidate, perhaps surprisingly, is Europe. The investment excesses were smaller there, and the financial adjustment in the UK has been significant.

We think fundamental constraints—not geopolitical concerns—are, and will remain, the major obstacle to a robust investment recovery. If history is a good guide, an investment recovery is clearly overdue. But we think history will be an imperfect guide. Weak demand growth, soft equity markets and continued deleveraging are all part of the broader adjustment to serious global imbalances. If we are right that these imbalances are not yet fully resolved, investors may be disappointed by the capex recovery for a while longer. ■

Further information on the topics in this report is available on the GS Financial Workbench^sm. For access, please go to www.gs.com/ceoconfidential

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Lessons From the US Boom and Bust

'Those who cannot remember the past are condemned to repeat it.' We offer seven boom-and-bust lessons to contemplate

1. In the long run, profits grow in line with nominal GDP

When productivity growth accelerates, firms initially capture most of the benefits, because wage gains have inertia. But workers eventually catch up, and the productivity windfall is competed away via higher nominal wages and a lower inflation rate.

This implies disappointing profit growth in 2003. Nominal GDP is likely to rise by less than 4% this year. Productivity growth should slow sharply, as it typically does in the second year of an expansion, and this will compress corporate profit margins. Thus, corporate profits are likely to rise more slowly than nominal GDP.

2. Disinflation generates high financial market returns, but low inflation is accompanied by much lower returns

Disinflation is good for financial asset performance. But once inflation stops falling, or when it is so low that deflation becomes a meaningful risk, financial asset returns fall sharply. If the monetary authority is successful in preventing deflation, bond investors no longer benefit from actual inflation falling below expected inflation. For equities, the sharp rise in prices as the equity risk premium shrinks is followed by much less rapid gains once the equity risk premium stabilizes.

This implies that future financial assets returns are likely to be much lower than during 1982-1999, when a market portfolio of 60% equities and 40% bonds earned a compound annual rate of return of about 15% per year.

We estimate that the long-run return on such a portfolio today would be only about 6% per year. Investors can expect long-run annual returns of about 5%-6% for bonds and about 6%-6.5% for equities, assuming 1) nominal GDP growth is about 4.5% per year (1.5% inflation and 3% real GDP growth); 2) S&P 500 earnings grow slightly slower than nominal GDP (this has historically been the case as mature companies dominate the index); and 3) a return of about 2.5% per share from dividends and share buybacks.

The downward adjustment in return expectations is not complete. Most companies are still assuming pension-fund returns of 8% or higher, and equity analysts' median long-term earnings growth estimate for the S&P 500 index is still about 13% per year. This is considerably above the 11% rate in 1991, despite the fact that inflation is lower now.

3. A stock market boom sows the seeds of its own demise

The 1990s saw many bold predictions made about the stock market. One widely reported argument claimed that equities were no more risky than bonds; an equity risk premium of zero implied, all else being equal, 36,000 for the Dow Jones Industrial Average.

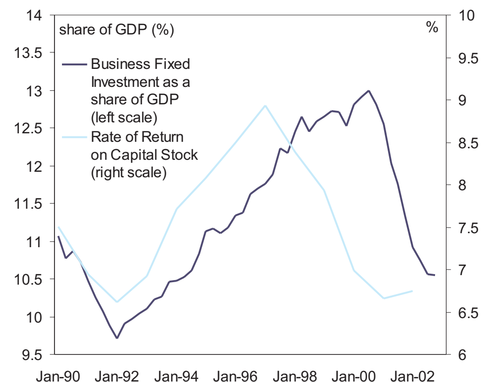
But why should the equity risk premium be zero? With their subordinate claim on a company's cash flow, equities cannot have the same level of risk as a more senior claim (debt), let alone a risk-free asset such as Treasury securities.

More importantly, the argument neglected the interaction between the equity market and the economy. At a Dow of 36,000, the market value of equities and debt would be far above the replacement cost of the firms' assets. This would lead to more investment, which would depress the rate of return on capital. Profits would fall, keeping the index well below 36,000.

This is precisely what happened. The rate of return on capital actually peaked in 1997, three years before the end of the bull market in equities and the investment boom. The good news is that this means the recent decline in the stock market must ultimately be self-limiting, as the weaker equity market leads to less investment. Over time, this will raise the return on capital by eliminating any capital overhang.

Investors should be skeptical about the federal government's ability to engineer a permanent increase in the level of the stock market via changes in tax policy. A lower cost of equity capital will lead to more investment over time, which will reduce the return on capital and push the equity market back down.

An Investment Boom Leads to Its Own Demise



4. The stock market and the economy interact to generate both virtuous and vicious cycles

The equity market and the economy are joined through several channels. 1) The performance of the equity market affects consumption and saving; this wealth channel has become more important over the past decade. 2) A strong stock market supports investment by lowering the cost of equity capital and by reducing the cash flow needed to fund defined benefit plans. 3) A robust equity market bolsters federal and state government finances. During the boom, these channels created a virtuous cycle.

Now they are running in reverse. Households are saving an increasing proportion of their income; investment is weak as corporations are increasing their contributions to defined benefit pension plans; and state governments are raising taxes and cutting spending in response to large projected operating deficits. As a result, the US economy will be weaker for longer than is generally anticipated.

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The Short-Run Matters for the UK and the Euro

By June, the UK Treasury will have judged whether the country is ready to join European Monetary Union (EMU). We expect it to conclude that the timing is not right, partly because of concerns about transitional costs—namely the need to tighten fiscal policy prior to entry to offset the expansionary effects of a lower real exchange rate.

The Treasury's comprehensive assessment will focus on the government's 'five economic tests,' one of which is whether there can be sustainable economic convergence between the UK and Euroland. Although convergence is really a question about the long-run, short-term transitional issues involving the exchange rate, fiscal policy and imbalances in the UK economy go to the heart of the convergence test.

A cut in interest rates, needed to align the UK's with Euroland's, could fuel an unsustainable consumer boom. The imbalances in the UK economy are unprecedented, and it is hard to see how they can correct without the real exchange rate playing a part. And the exchange rate may still be considerably overvalued relative to its long-run equilibrium rate.

Three Scenarios for the Transition

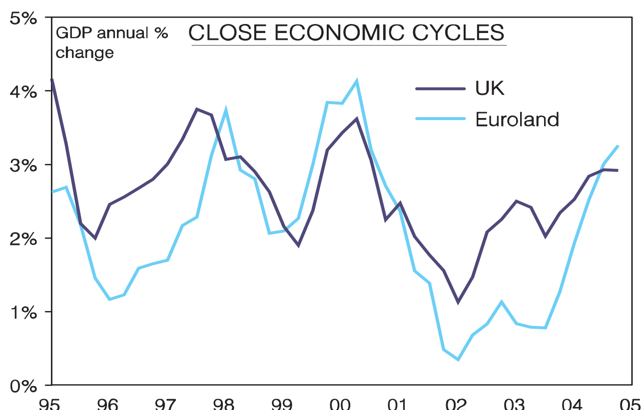
If the government wants to join EMU at a lower exchange rate, policy needs to be tightened to offset the expansionary effects of a lower real exchange rate on demand and higher import prices. We see three options for the transition. In each case, we assume an entry rate of EUR/£0.73, equivalent to a 7.5% depreciation of sterling against the euro and around a 5% depreciation on a trade-weighted basis.

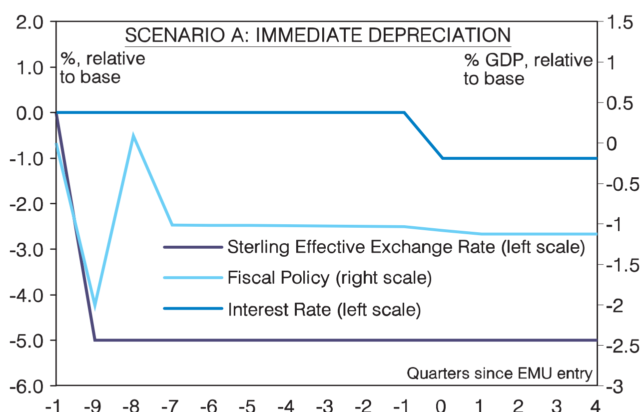
- **Scenario A:** If the government wants to keep inflation stable, demand must fall by just over 1% of GDP. All the burden falls on fiscal policy, because monetary tightening would be inconsistent with exchange-rate stability.

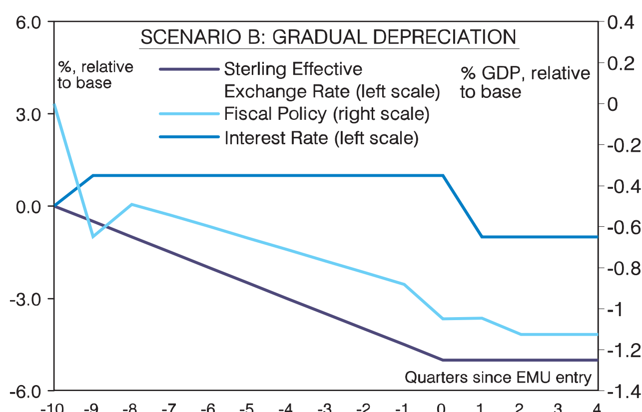
- **Scenario B:** If the government allows monetary policy some role in controlling inflation during the transition, the exchange-rate depreciation will be more gradual. Higher interest rates would lessen the anti-inflation burden on fiscal policy, which could be tightened more gradually. We assume a tightening of around 0.5% of GDP in 2003 and a further 0.25% of GDP in both 2004 and 2005.

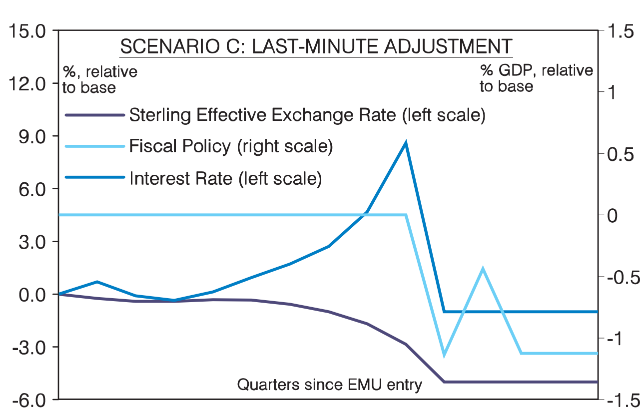
- **Scenario C:** If fiscal policy is left unchanged during the transition, only higher interest rates can counteract the inflationary effects of a lower exchange rate. The months before EMU entry would probably see sudden and volatile movements in the exchange and interest rates. This would seem to breach the Maastricht Treaty requirement that the exchange rate be fairly stable in the two years before entry.

Without an autonomous adjustment in consumer spending, the burden of adjustment will ultimately fall on fiscal policy, forcing it to tighten by just over 1% of GDP for each 5% decline in the real exchange rate. Given the UK government's declared objectives of improving public services, this implies higher taxes as the transitional cost of joining EMU. The tightening would of course be much smaller if the Treasury concludes that the pound is already close to a suitable rate. But then the government would risk locking the UK into EMU at an overvalued rate, increasing the potential for many years of painful adjustment. ■









Source: Goldman Sachs.

The Dollar Heads Still Lower

The US dollar has had yet another bad month, losing further ground against a basket of its main trading partners. On a broad trade-weighted basis, the dollar is down by 6% from its January 2002 highs. It is currently unclear how much of the dollar's weakness reflects geopolitics and how much is a fundamental unwinding of its previous overvaluation.

We think the weakness is driven by fundamentals,and we expect the dollar to weaken further over the coming year on the back of deterioration in the trade deficit and slowing capital inflows. Our forecasts see EUR/$ rising to 1.12 in three months and 1.18 in 12 months (against a spot rate of 1.08); for $/Yen the forecasts are 115 and 111 (from 118 now).

US Trade Deficit Widens While Capital Flows Weaken

We expect the US balance of payments to deteriorate from a deficit of 1.9% of GDP in 2002 to a deficit of 3.1% of GDP in 2003. The main driver of the deterioration remains the current account, which we expect to reach $600 billion in 2003 as the gap between export and import performance widens.

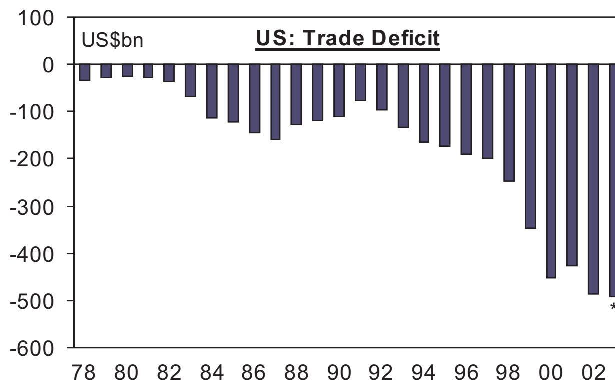
The softness of overseas demand and past dollar strength are keeping US exports weak. In contrast, US import growth remains buoyant, reflecting the strength of consumption-related demand and also some possible inventory rebuilding. It is also likely that the previous strength of the dollar may have caused further import penetration by foreign producers.

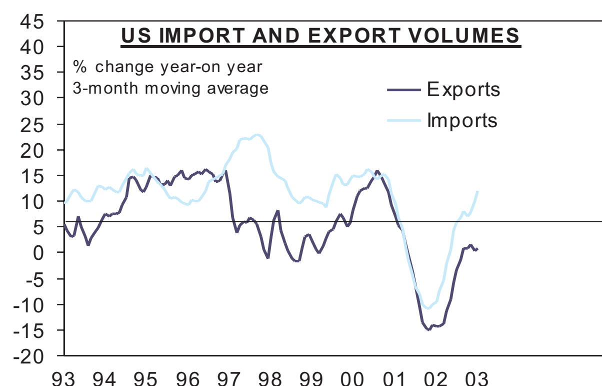
At the same time, we see smaller net inflows into US securities. Foreign net activity in US corporate and agency bonds has recently slowed sharply, despite notable net inflows into US Treasuries. Even if net capital inflows remain strong, the trade deficit would still push the US broad balance of payments further into deficit. If net capital inflows slow, the risk of an even larger decline in the dollar would grow significantly.

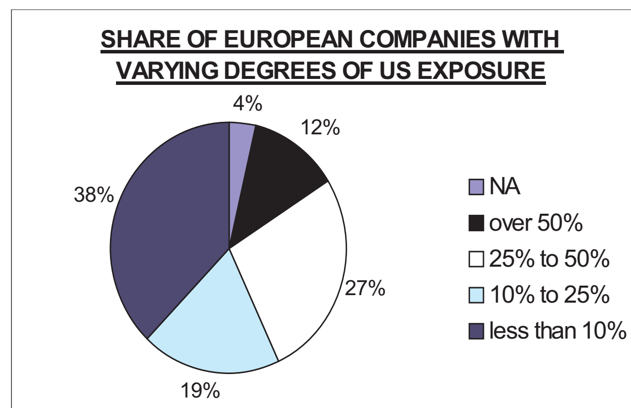
Dollar Weakness Will Hit Europe

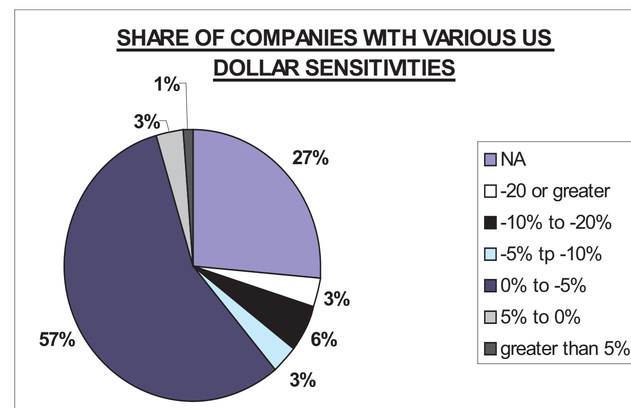
We recently surveyed our European equity-research analysts on company exposure to moves in the dollar and found that in aggregate, European companies have significant profit exposure to the US. For the overall European market, we estimate that a 10% decline in the value of the dollar would reduce earnings by up to 4%. The countries most exposed to the US are the Netherlands, Sweden, Switzerland and the UK. Swedish companies tend to offset their currency exposure by hedging and holding debt denominated in US dollars, so the overall sensitivity of Swedish companies is relatively low. Dutch and UK companies do not use offsets to the same extent.

Pharmaceuticals, construction, capital goods, autos, business services, insurance and media have the highest profit exposure to the US. Pharmaceuticals and construction companies tend to be well hedged, while insurance and capital goods are generally less well protected. Oil and IT hardware are also sensitive to the dollar. ■









Source: Goldman Sachs.

THE WORLD IN A NUTSHELL

	Outlook	Key Issues
United States	Labor demand is contracting, consumer spending is stalling, and the inventory cycle in manufacturing is petering out. Altogether, the risk of recession currently appears to be 30% to 40%. We think growth will stay below-trend in 2003 at 2.1%, rising in 2004 to 3.0%. The poor data reinforce our long-standing view that the Fed will ease monetary policy again, although we think they will wait until the second quarter.	Although energy prices aggravate downside risks to the US economic outlook, the price increases to date are not enough to push the economy into recession on their own. The most reasonable assessment of the impact of energy price increases is that they will reduce real GDP growth by about 0.5 ppt. Most of this is already in our baseline forecast, as we have assumed only a modest easing in energy prices from current levels over the rest of the year.
Japan	The V-shaped recovery in corporate earnings has not led to a recovery in capex because corporations remain focused on balance-sheet adjustment. While restructuring stagnates in the nonmanufacturing sector, steady progress is being made in the manufacturing sector, primarily in the chemicals and transportation machinery industries.	We hope the BOJ will achieve three things under its new leadership. The first is coordination with fiscal and forex policy. The second is integration of monetary policy and structural reforms: it is important to enhance the effects of quantitative easing by accelerating nonperforming loan (NPL) disposal. The third is increased dialogue with the markets.
Europe	The impressive rebound in Euroland industrial production is likely to be a once-off correction from a slump in December, rather than the start of a strong recovery. Demand growth is not strong enough for a more sustained upturn. With the ECB forced to focus on Germany, monetary policy is becoming accommodative for the rest of Euroland. Eventually, this will result in inflation stabilizing above 2%.	We think fears of deflation in Germany are overdone. Low inflation in Germany is a necessary part of the adjustment process in EMU. Lower interest rates should enable the rest of Euroland to pull Germany up. In the absence of supply-side reforms, the long-term growth rate of the German economy will remain poor. However, we see tentative signs that the climate for reforms is improving.
Non-Japan Asia	Apart from China, we expect another year of sub-par growth in non-Japan Asia in 2003. Our forecasts are above consensus in most of developing ASEAN and below consensus in Korea, Australia and China. 2004 offers much brighter prospects—but first Asia must cope with oil, a weaker US dollar and the question of whether global (and Asian) capex will revive before the consumer collapses.	The biggest risk for Korea is a terms of trade shock. Korea is the most exposed in Asia to an oil price shock. The export price index has shown little recovery since early 2002, and the 20%-25% pace of export growth seen recently is unlikely to be sustainable. We expect domestic policy to ease this year, both on the monetary and fiscal front. The risk is that easing is 'behind the curve'.
Latin America	We are reducing our 2003 forecast for real GDP growth in Mexico to 2.5% from 3.0% because of softer US growth and uncertainty around Mexico's Congressional elections in early July. Competitive pressures from China and other exporting nations are unlikely to abate in the near-term. To avoid a longer period of sluggish growth, the government must push through structural reforms.	Brazil's administration has correctly prioritized social security and tax reforms, but it has not fleshed out what shape these reforms will take. Congressional approval is key to consolidating this administration's credibility. It is critical for the government to make progress on the reforms by June to benefit from President Lula's political capital and to bolster confidence.
Central and Eastern Europe	We see growth gradually recovering in 2004 to 4.6% from 3.7% in 2003. The recovery will be driven by stronger exports, fueled by stronger EU domestic demand. With EU performance split between poor performance in Germany and robust growth elsewhere, Central and Eastern European growth will reflect each country's relative dependence on Germany.	Ten Central and Eastern European countries are set to join the EU in just over a year, and most of them will proceed straight into ERM-2 with an intention to adopt the euro two years later. Between now and mid-2004 we see increasing tension between the underlying fundamentals, which will push the Central European currencies stronger, and policymakers' efforts to prevent this.

KEY ECONOMIC AND MARKET FORECASTS

	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
US	2003: 2.1 2004: 3.0	2003: 2.3 2004: 1.5	3m: 1.3 12m: 1.3	Current: 3.7 12m: 4.5	-- --
Japan	2003: 0.8 2004: 0.4	2003: (0.5) 2004: (0.3)	3m: 0.1 12m: 0.1	Current: 0.7 12m: 1.1	3m $/JPY: 115 12m $/JPY: 111
Euroland	2003: 0.9 2004: 2.7	2003: 1.7 2004: 1.7	3m: 2.2 12m: 2.2	Current: 3.9 12m: 4.1	3m EUR/$: 1.12 12m EUR/$: 1.18
UK	2003: 2.3 2004: 2.8	2003: 2.7 2004: 2.4	3m: 3.8 12m: 4.1	Current: 4.2 12m: 4.2	3m GBP/$: 1.60 12m GBP/$: 1.62
Non-Japan Asia	2003: 6.3 2004: 6.8	2003: 1.2 2004: 1.4	3m: 4.3 12m: 4.3	Current: 7.4	3m $/KRW: 1325 12m $/KRW: 1200
Latin America	2003: 0.7 2004: 3.2	2003: 12.0 2004: 11.9	3m: 8.5 12m: 9.1	Current: 10.5 12m: 10.1	3m $/MXN: 11.25 12m $/MXN: 11.15
Central and Eastern Europe	2003: 3.8 2004: 4.6	2003: 4.6 2004: 2.5	3m: 5.9 12m: 5.0	Current: 5.3 12m: 5.0	3m EUR/PLN: 4.10 12m EUR/PLN: 4.05

* 3-Month Rates: Euroland: average of Germany and France; Non-Japan Asia: Korea; Latin America: Mexico; Emerging Central Europe: Poland.
** Bond Yields: US: 10-year Treasury note; Japan: 10-year JGB; Euroland: average of Germany 10-year Bund and France 10-year OAT; UK: 10-year Gilt; Non-Japan Asia: Korea 5-year sovereign; Latin America: Mexico 5-year sovereign; Emerging Central Europe: Poland 5-year sovereign.

Lessons From the US Boom and Bust

Continued from page 3

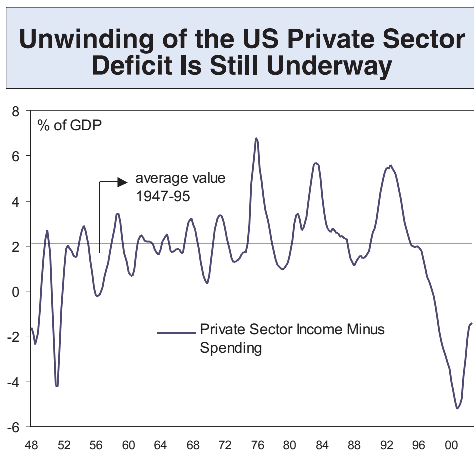
5. These virtuous and vicious cycles cause markets and economies to overshoot

The forces that set a boom or bust underway tend to exacerbate the reasons for optimism or pessimism that began the cycle. As the equity market rose, it encouraged greater investment, which lifted earnings temporarily. The rising market also boosted reported earnings through the use of options-related compensation as a substitute for wages and through pension fund asset appreciation. The result on the upside was a reinforcing virtuous cycle.

Similarly, consider the strength of the dollar during the boom. Foreign monies flooded into dollar-denominated assets. This caused the dollar to appreciate, which held down inflation and kept the Federal Reserve mostly on the sidelines. This helped make the US economy more attractive to foreign investors, encouraging further capital inflows.

The same overshooting phenomenon occurs with economies, with the US investment boom and bust being the most recent example. The correction does not appear to have run its course. For example, the private-sector balance has not yet returned to its long-run average value.

Unwinding of the US Private Sector Deficit Is Still Underway



6. Monetary policy works through many channels and should be evaluated on that basis

Economists were too pessimistic about the growth outlook during the boom and have been too optimistic during the bust. In part, this reflects too much focus on the real federal funds rate and too little on how financial conditions influence the impulse of monetary policy.

During the late 1990s, real GDP growth stayed strong despite a relatively high real federal funds rate; it has been weak since the bust despite the Fed's aggressive easing efforts. Financial conditions have done a superior job in explaining the economy's performance. The Goldman Sachs Financial Conditions Index eased from 1995 through early 1999 but has generally tightened since. The economy is not likely to grow quickly unless financial conditions become significantly more accommodative and/or fiscal policy becomes more stimulative.

7. Policymakers should lean against the wind to temper booms and busts

For monetary authorities, this means taking asset bubbles and busts into consideration in setting policy. Booms and busts can make it more difficult for the monetary authorities to achieve their long-term inflation targets; they can also result in the misallocation of capital, which harms long-term economic performance.

On the fiscal side, the message is straightforward. During booms, revenue windfalls should be saved, not spent. During busts, fiscal levers should be used aggressively. However, the stimulus should be applied in a manner that can be easily reversed once the bust is over. Fiscal stimulus is appropriate, but policymakers should be careful not to wreck the long-run budget outlook. ■

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CEO CONFIDENTIAL

How Fast Is China Really Growing?

Since the mid-1990s, Chinese official growth figures have shown an all-too-predictable real GDP growth of 7%-9%. Sceptics ask whether this can be true. Our new index of Chinese economic activity shows bumpier growth but a strong outlook; we expect average annual growth of 7.5%-8% over the next three to five years

Since the mid-1990s, at a time when China's neighbors were successively swayed by the Asian financial crisis, the global IT boom and the subsequent bust—and when China itself faced the aftermath of a domestic bubble—outside observers have found it difficult to believe that the country could yield such buoyantly consistent growth. The most pessimistic view holds that China's economy has barely expanded since the Asian crisis.

Despite enormous improvements in the quality of statistical data, Chinese national accounts statistics still do not fully represent some of the country's most dynamic sectors (such as services and smaller private enterprises); they have also been subject to non-economic pressures.

Other evidence suggests that China went through a sharp economic slowdown beginning in 1996, and then a rapid recovery from 2000 onward—neither of which were adequately captured by official data.

Our best estimates point to growth rates well in excess of the official figure of 8%. Rather than being used to paper over a moribund economy, the real problem with China's growth statistics is that they err on the side of stability, smoothing out valleys and peaks.

We look at two alternative indicators of Chinese growth: expenditure-side national accounts and our own calculations. The alternative official data gives more power to professional statisticians, but it is less timely. This shows a much stronger slowdown in real growth in the late 1990s, from a rate of 12% in 1995 to under 5% in 1999, followed by a rapid recovery in the last two years to over 10% in 2002.

Our own proxy index of economic activity shows an even sharper V-shaped trend. The Goldman Sachs China Activity Index (GSCA) comprises a wide range of alternative demand-side and supply-side indicators, including imports, exports, passenger and freight haulage, energy usage, building construction, corporate profits and a range of physical production indicators—well as official data on consumption and investment demand.

The GSCA tells much the same story as the alternative official data, with an even more pronounced downturn in the second half of the 1990s. Growth momentum slowed from 10% in the first half of the 1990s to only 3.5% in 1998; it has since increased significantly, to nearly 10% in 2002.

Is China About to Explode?

The key benefit to our alternative index—in addition to having a 'second opinion' on the official data—is the frequency of the data. We can now gauge economic trends in real time (at least by Chinese standards).

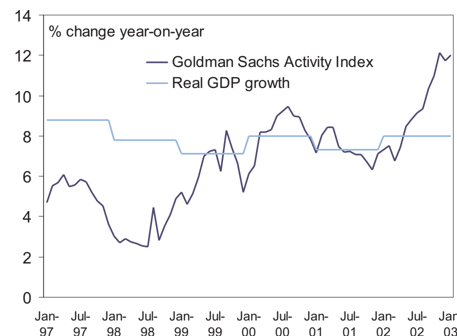
The most striking feature in the monthly index data is the enormous upturn in the second half of 2002, after a relatively weak 12 months. January showed a 12% year-on-year increase. Does this mean that Chinese growth has caught fire, leading to another boom in 2003 and 2004?

We think this strong outperformance is not sustainable. Growth for 2002 as a whole, while favorable, is nowhere near as high as that in the second half. Much of the boom reflects a 'bunching' of activity in the second half, due to delayed trade, consumption and credit transactions in the earlier WTO accession period. In other words, year-on-year growth is very high because last year's base was low.

We expect our index will continue to show high growth rates over the next few months, but we expect to see a noticeable shift in the second half of 2003, when the low-base effect shifts to a high-base effect. Growth rates could temporarily drop well below trend growth.

But we do look for stable, high growth over the next few years. Most of the factors commonly seen as macroeconomic risks—the weak banking system, ongoing restructurings and bankruptcies of state-owned enterprises, fiscal pressures and low rural income growth—are overstated in the near term. We see them as ongoing medium-term priorities with which China can and should deal before they become a greater drag on growth down the road.

GS China Activity Index Shows a Steeper Decline and a Stronger Pickup Than Do Official Data



Equally important is the fact that China is not a 'bubble' economy, as it was during the early 1990s. There are also clear new drivers of growth, including:

- the rapid development of a national economy, with investment in transportation and communications infrastructure and the removal of internal trade barriers stimulating a new period of corporate expansion;
- new guidelines on privatization, mergers and acquisitions adopted last year;
- rising urban incomes and greater access to consumer finance, which have visibly driven demand for residential housing, automobiles and IT goods; and
- the ongoing liberalization of equity markets and—we hope—further recapitalization of the state banking system, which is necessary to increase financial flows to dynamic smaller and private enterprises.

Barring unforeseen shocks, we expect the Chinese economy to grow at an average rate of 7.5%-8% over the next three to five years. ■