Chinese Leading Economic Indicators: An Alternative Approach…

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Predicting turning points in a country's business cycle is extremely difficult, but a large body of research provides empirical evidence that Leading Economic Indicators can assist policy makers and investors in assessing growth momentum. However, simply applying well internationally established leading indicator approaches to China without taking account of the distortions created by the country's unique policy driven growth model, which acts to smooth cyclical GDP fluctuations (as implemented via fixed investment funded by still dominant state controlled banks) in our view undermines the value of the lead indicator approach.

An additional complication is that high frequency data series have a very short history in China and there is a very limited range of economic metrics to choose from. This means that there is insufficient historical evidence to choose components of a composite leading index based on empirical performance alone. In this paper, we examine the shortcomings of the three existing economic lead indicator series published for China by the National Bureau of Statistics, OECD and most recently the US Conference Board. We do this in the context of the distortions within the country's financial system (as identified by the PBoC via its policy focus since 2010 on 'total social finance') which make M2 and RMB lending growth potentially misleading financial sector components in estimating GDP cycle inflection points. *The primary question we seek to answer with our index is: how well it is likely to predict future economic activity and its major fluctuations for China as the economy becomes increasingly influenced by market-based economic activity?*

We examine an alternative series of principal index components for a composite leading index with superior informational content, which are assessed using the standard Stock-Watson diffusion index methodology. We examine overcoming existing data deficiencies by including metrics such as Asian supply chain proxies for domestic industrial momentum (Korean/Taiwanese/Japanese component exports to China) and a measure of aggregate credit growth to reflect the growth of the country's 'shadow' banking system. We evaluate our selection of leading indicators empirically in terms of leads and correlations against the chronology of business and growth cycles, as established by Guo et al. (2009), with cyclical turning points determined by the Bry-Boschan algorithm.