



China to grow at a faster pace, EU, U.S., Japan to see slow growth

Why is this chart important?

The chart highlights recent trends in the Purchasing Managers Index (PMI). The magic number is 50: a reading above 50 indicates an expansion of the manufacturing sector and below 50 a contraction. The PMI is considered a good indicator of future GDP levels: if manufacturing is expanding, the general economy is likely to follow. The chart shows that China's manufacturing is expanding, and possibly - as in Emerging Asia manufacturing accounts for nearly 30 percent of total value added - that the Chinese economy is going to grow faster. In the EU, the U.S. and Japan, conversely, industrial production continues to deteriorate, although at a slower pace.

What does this indicator tell us?

The PMI assesses how the manufacturing sector is doing. It covers previous month's data and is compiled via a survey of a large number of managers. Each surveyed manager has three possible responses ("faster," "same," or "slower") and provides his assessment on five major areas of business: 1) What about the new orders from customers? 2) Are inventory levels moving? 3) How is production coming along? 4) How are supplier deliveries coming? And 5) How is the employment environment?

Next, the PMI is constructed as a composite index of these five indicators, where each indicator has a different weight and the data are adjusted for seasonal factors. The resulting number (which can range from 0 to 100) highlights the percent of respondents that reported "better conditions" than the previous month. Thus, a PMI reading of 50 would indicate an equal number of respondents reporting "better conditions" and "worse conditions." When reading the PMI, what matters is the rate of change from month to month. A reading of 45 (the manufacturing industry is contracting) coming after a month with a reading of 40 is seen favorably by the markets, especially if the economy



Source: US/ISM, EU and Japan/MARKIT, China/NBS, 2009.

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has been showing negative growth. Also, a key area is the growth in new orders, which predicts manufacturing activity over the next few months. Finally, the PMI is a very important hybrid indicator: it has actual data elements but also confidence elements, as answers reflect subjective market sentiments.

What are the implications for the economy and the financial markets?

At the end of 2008, the manufacturing sector was hit very hard by the global economic downturn. Credit got

scarcer by the day, consumers pulled back, and firms reacted by aggressively cutting production. As a result, output contracted more than final demand, and inventories fell. Today, as government large-scale fiscal stimuli and very accommodative monetary policies are helping stabilize consumption and improve credit markets, firms are raising production levels, mainly to slow the pace of destocking. Consistent with this improvement is the recent recovery in trade flows.

The most recent PMI data capture this rebound in all major economies.

U.S., EU, and Japan:

In the three biggest economic areas of the world, both production and inventory were reduced sharply during the last quarter.

The last reading of the PMI is still below 50, suggesting an ongoing contraction in manufacturing activity. However, the upward trend indicates a decline in the pace of contraction. Also, in a few key areas, such as new orders and production, there are signs of improvement. For example, the "new orders index" in U.S. went above 50 for the first time since Nov. 2007.

China:

The PMI data point to an expansion of the manufacturing sector (June 2009 was the fourth straight month of production growth), stimulated by improvements in business and market conditions. In particular, 14 of the 20 industries surveyed in June recorded PMIs above 50.

These results indicate that: a) the rebound is under way in China; b) the operating conditions in the manufacturing sector might have stabilized, thanks to strong domestic demand and an improving export situation; and c) a growth momentum may be building. The PMI is one of the most widely followed economic indicators by the financial market. When its reports a change - especially if unexpected - it is usually followed by a quick reaction in stock trading. The recent upturn of the PMI has been widely hailed as indicative of "green shoots." The readings for the next few months will be crucial in assessing if the supposed "green shoots" are real, i.e., the recovery in final demand is genuine - or if (more likely) the recent rebound is largely due to inventory re-stocking, and - unfortunately - sustained growth is not behind the corner.

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