

## **China's slowdown: When the dragon catches the flu, Europe sneezes**

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**25 September 2015**

**A**t the same time that Stieg Larson's *The girl with the Dragon Tattoo* is making a comeback in bookshop windows, the Chinese economic dragon seems to be slowing down. Disregarding the erratic response from stock markets around the world (which in any case often change their mind by the hour), we argue that while a slowdown of the world's second-largest economy may not be good news for Europe, its effects will not be as bad as headlines would have us believe. In the short term, the biggest risks from the Chinese slowdown may be political, stemming from a weakening of the Renminbi, either from actions taken by China's central bank and/or from large capital outflows.

As argued by Gros (2015), the recent Chinese expansion fuelled largely by domestic investment (with gross fixed-capital formation at 46% of GDP in 2013) was unsustainable and doomed to taper off. The IMF (2015) had already factored in a persistent slowdown to around 6% annual growth in its 2015 forecasts, although the European Commission (2015) is slightly more optimistic. The latest market turmoil has made only a limited impact on the recent OECD's September forecast for the world economy and, indeed, the OECD (2015) sees a slight improvement for the euro area in 2015. Against this background, one important question relates to the speed of adjustment of the Chinese economy towards a more sustainable path, including a rebalancing towards more consumer goods-driven growth, as well as the reaction in financial markets.

What if the slowdown turns out to be more abrupt? Commentators (see FT, 2015 among others) are concerned that current official growth figures are not accurate and significantly overstate current growth rates. Some argue that actual growth is running closer to 4% than 6%, and that there is a risk of a drop to 3% or even more.

What would be the short-run impact of a growth slowdown to, say, 3% rather than 6% per year on the European economy?

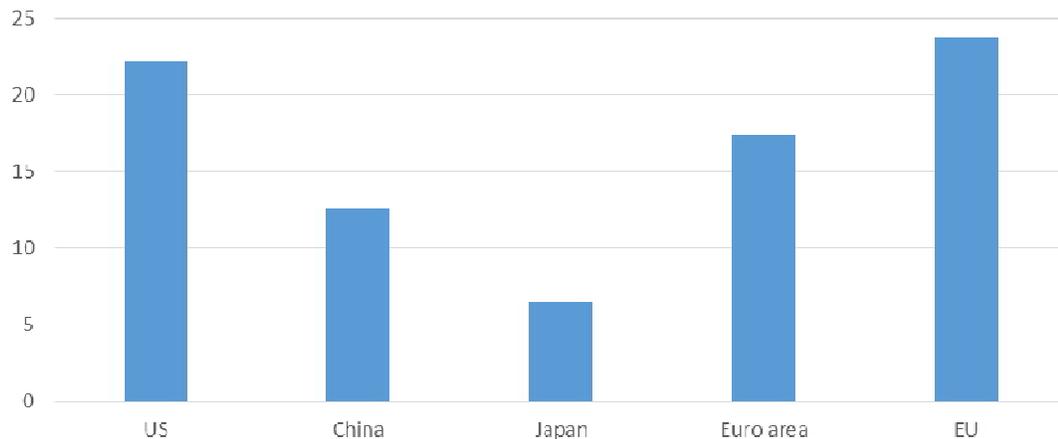
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The first thing to note is that China made up 13% of the world economy in dollar terms in 2013 (Figure 1). Although this makes it the second-largest country in the world measured by GDP, it is still 30% smaller than the euro area and around half the size of the EU.

Figure 1. Share of world GDP for major economic regions, 2013 (\$).



Data source: WEO, 2013.

This implies that a 3 percentage point reduction in Chinese growth translates into a direct (partial equilibrium) effect of a 0.4% slowing of the world economy. General equilibrium effects, operating primarily through the slowing of growth among commodity exporters and south-east Asian economies tightly linked with China, will exacerbate this situation. This prospect should be seen against forecasted world GDP growth of 3.6% this year and 4% in 2016.

Another yardstick against which to measure this number is the world economic growth effect of the recent decline in the price of crude oil. While price changes in natural resources lead to a reallocation of wealth, it makes a difference to world economic growth how the money is spent. The IMF estimates that the 50% drop in crude oil prices in the period June 2014-May 2015, from the initial price of \$110/barrel, will increase world GDP by around half a percentage point in 2015 and 2016 (Husain et al., 2015). Estimates for the effect on GDP growth in the euro area would be somewhat higher applying the findings from the European Commission (2012).

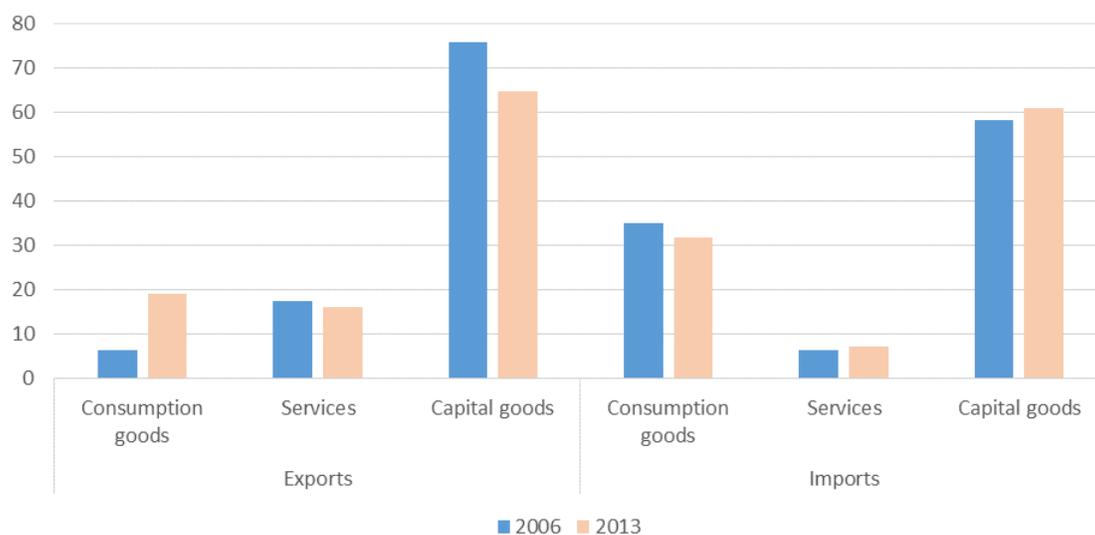
Just as high commodity prices (including oil) restrained economic growth in the EU when China had double-digit growth rates, lower commodity prices are likely to cushion the economy against the effects of lower Chinese (investment) growth. This is particularly true for the EU where commodity exports are low. In addition, it is worth noting that lower commodity prices exert a direct effect on aggregate demand, whereas the effect of lower export demand works through lower returns to production factors in affected industries, and hence has a second-order effect.

Without underestimating the relevance of China as a market for EU exports, it is a fact that EU exports to China are not more important than those to Switzerland. In 2013, the total exports of goods and services from the EU28 to Switzerland was 25% larger

than those to China, i.e. about €225 billion against €180 billion. EU exports to the US are worth more than twice its exports to China.

Furthermore, if successful rebalancing away from investment and towards services and consumer goods is part of China's slowdown story, the EU is likely to feel better faster. Although services exports have grown no faster than goods exports in recent years, the export of consumer goods is making up an increasingly larger share of total EU28 goods exports to China, as shown in Figure 2.

Figure 2. Distribution of total EU28 exports China



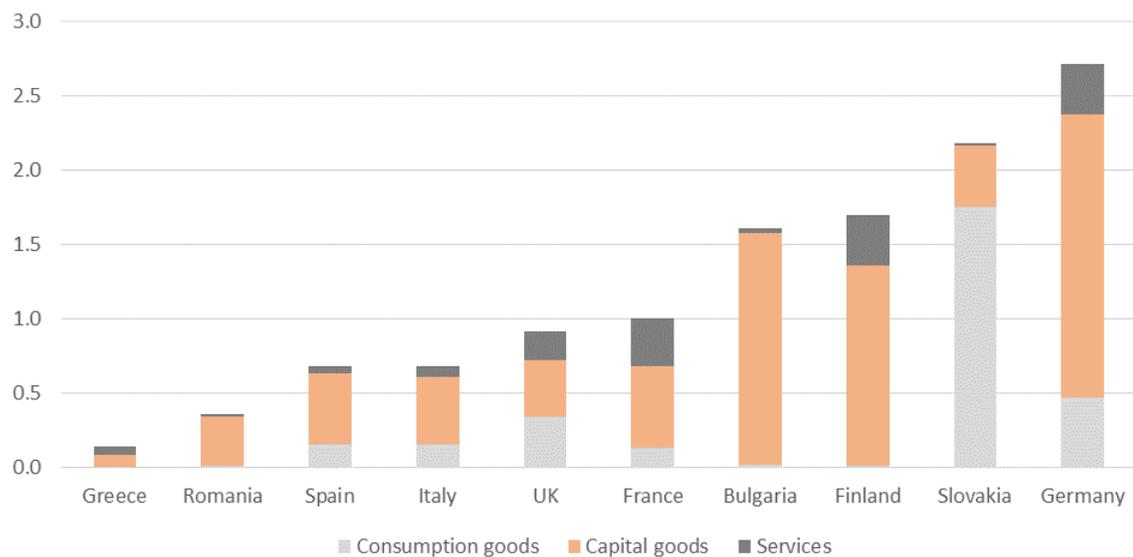
Note: We break total exports down by services, capital goods and consumer goods. The following BEC categories are used to group consumer goods: 51, 61, 62, 63, 112, 122 and 522.

Source: UN Comtrade statistics, Eurostat.

### Who will cough the most?

Struggling countries in the eurozone's periphery have rather small direct exposures to China (Figure 3). Germany will be affected the hardest because of its relatively large share of exports to China, but also because the composition of its export is heavy in machinery. Finland and Bulgaria may be the least well-equipped to handle a China downturn. Both have above-average export shares (as a percent of GDP) to China and at the same time they barely export any consumer goods or services.

Figure 3. Exports to China as a share of GDP in selected EU countries, 2013 (%)



Note: The following BEC categories are used to group consumer goods: 51, 61, 62, 63, 112, 122 and 522.

Source: UN Comtrade statistics, Eurostat.

## Conclusions

Since slower Chinese growth goes hand-in-hand with lower commodity prices, the latter is likely to provide EU countries with a strong offset for lower Chinese export demand. As suggested by the arguments above, the wider EU implications look manageable. Furthermore, the burden of the slowdown is likely to fall on the EU's broadest shoulders and, in fact, may even contribute to a rebalancing within Europe. Lower German exports to China will be felt throughout the EU, but only as a second-round effect in those countries heavily dependent on intermediate exports to Germany.

If China's growth were to slow more abruptly than expected, the economic impact on EU countries may be larger and broader. In this case, one should also worry about how that would play out with domestic policy in China and abroad. The likely intervention by China's central bank to manage the slowdown could lead to a weaker Renminbi and spill over into a further widening of the current account deficit vis-à-vis the US. Such a move has gone down badly with US domestic politics in the past and is unlikely to be received any differently in a presidential election year.

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