

SEPTEMBER 8, 2023

Spillovers From China's Malaise

A hard landing in China would rattle Asian economies.



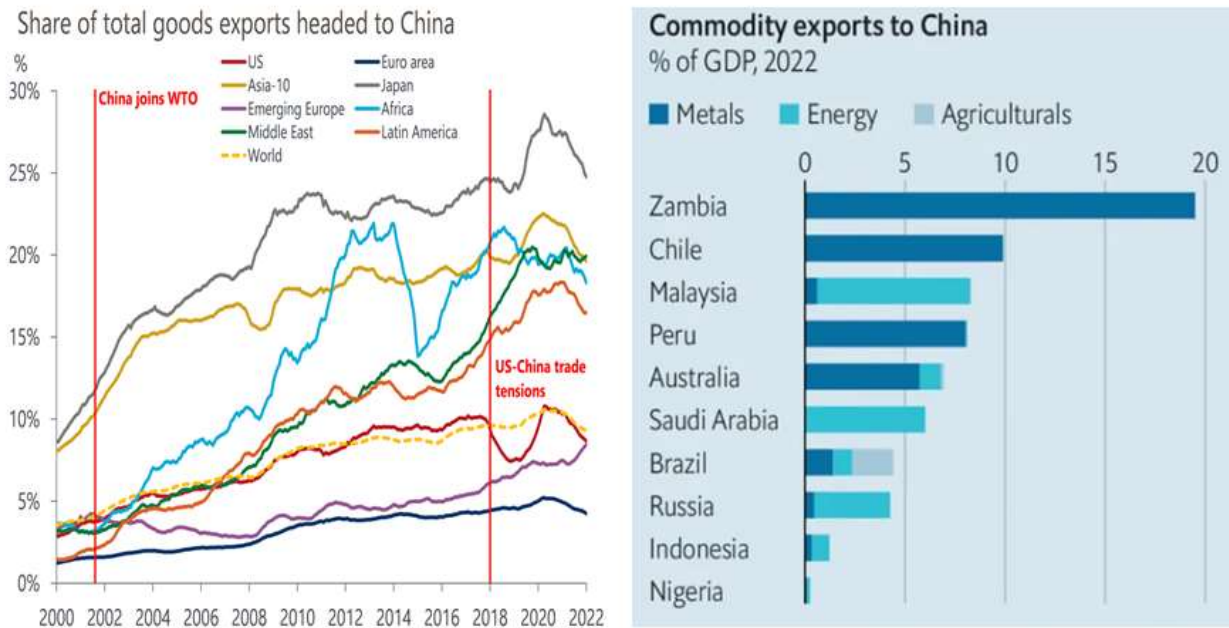
There is an old cliché that if the U.S. sneezes, the world catches a cold. It is used to highlight the spillover effects of trends in the world's largest economy upon other parts of the world.

With China's rise as an industrial powerhouse, developments there have broad global consequences. But I would propose an alternative cliché: when China's economy feels the heat, the world sweats.

After four decades of robust performance, China's economic growth is slowing and the soft patch is unlikely to be transitory. As we wrote [here](#) and [here](#), the Chinese economy faces a series of challenges that will be difficult to manage.

China has become a dominant worldwide player across a number of sectors. The country is the world's largest manufacturer and exporter of goods. Supply chains for

many industries are rooted in the country, earning it the title of the world's factory. China is also the world's largest purchaser of several key commodities, consuming about half of the global supply of basic metals and one-fifth of the global oil supply.



Sources: Oxford Economics, The Economist

With western nations expected to slow in 2023, the International Monetary Fund projected that China would account for over one-third of global growth this year. That forecast is unlikely to be realized.

China's economic woes are sparking warnings of contagion to other parts of the world. China's regional trading partners, along with commodity exporters, are especially exposed to its waning consumer and industrial activity. China is a key trading partner for south Asian economies, not only in goods but also in services such as tourism. The commercial hubs of Hong Kong and Singapore are especially vulnerable, given that Chinese demand accounts for 13% and 9% of their gross domestic product (GDP), respectively.

South Korea's exports fell in July at the steepest pace in more than three years, while factory activity there fell for the 14th month in a row in August on the back of smaller shipments of computer chips across the Yellow Sea. Vietnam, a key exporter of textiles, footwear and electronics is witnessing similar trends, with its shipments dropping 14% in the second quarter from a year earlier.

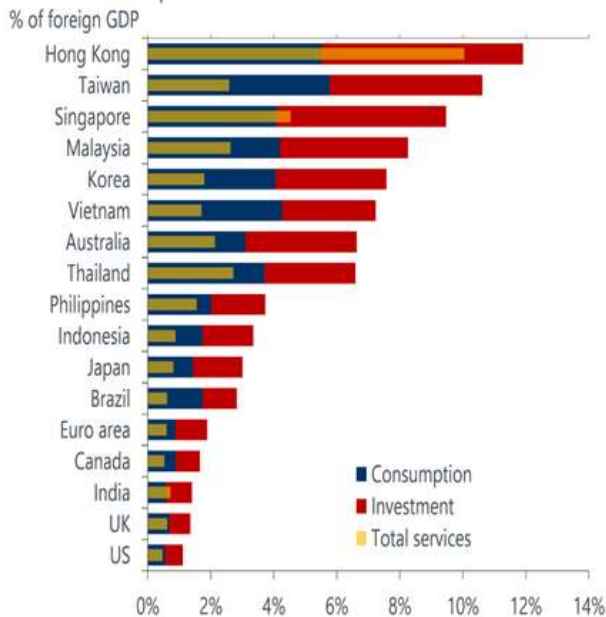
The Chinese property sector has been a significant source of demand for building materials. The current downturn in the industry means it requires less industrial metals like iron ore and copper. Even distant nations will feel the burden: Zambia exports 20% of its metals to China, as well as 10% of metals sent from Chile.

China is the most important destination for Australian and Japanese goods. Australia's trade surplus shrank more than expected in July as weak demand in China weighed on the exports of commodities like iron ore, lithium and natural gas. The Australian dollar is

trading at its lowest levels in almost a year against the U.S. dollar as China's economic prospects are being scaled back. Japan's shipments to its largest trading partner registered a decline of 13% year-over-year in July, led by drops in exports of major items like automobiles and integrated chips.

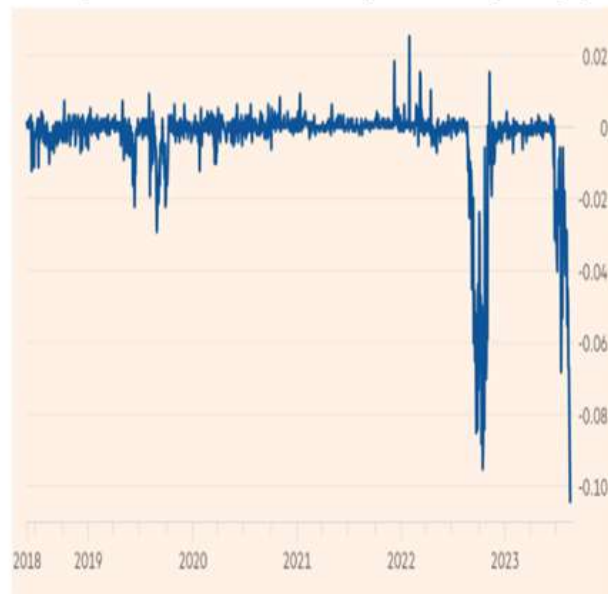
Owing to relatively small trade exposure to China, the negative growth impulse to western developed economies will be much more modest. Sales to Beijing account for only 4-8% of revenue for listed companies in America and Europe. Germany is an exception, as faltering demand from Asia's largest economy is one of the reasons behind the **economic stagnation** in the eurozone's largest economy.

Direct trade exposure to Chinese final demand



Sources: Oxford Economics, FT, Bloomberg

Difference Between Trading Band's Daily Midpoint Fix and Market Expectations (RMB/\$)



Historically, financial spillovers from China to the developed world were thought to be negligible or non-existent due to the fact that Beijing maintained a closed capital account regime, with limited financial links to the West. Some, like Nobel laureate economist Paul Krugman, are still of the **view** that even a 2008-style crisis in China is unlikely to lead to major global spillovers. But given the country's deepened integration into the broader global economy in recent years, a **hard landing** scare could generate spikes in global financial volatility.

Mounting concerns over the health of the Chinese economy and the widening interest rate differential with the U.S. have put pressure on the renminbi (RMB). The currency has dropped to a 16-year low against the dollar. The gap between expectations and the daily trading band's midpoint fix set by the People's Bank of China (PBoC) is the largest since the survey began in 2018, which shows the discomfort at the central bank over the sudden fall (see above chart).

Haunted by the recent past, when foreign reserves dropped by around \$1 trillion from 2014 to 2016, the PBoC has been hesitant to deplete its reserves in an effort to prop up

the value of the currency. Instead, it has used other measures such as cutting the foreign reserve ratio to provide support to the RMB.

A weaker renminbi could offer some support for the Chinese economy, given the deflationary environment at home and falling exports. However, a significant depreciation will have **unwelcome consequences**. Sustained pressure on the RMB will add to debt in domestic currency terms, thereby likely increasing leverage. And it could raise accusations of trade manipulation from the United States and others.

2023 has been the **hottest year on record** around the world. But as China stares at rising economic risks, the heat it feels is especially intense. Its business partners may find it very difficult to stay in the shade.

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