Investment Research & Analytics

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# CHINA SLOWDOWN
## Impact On Key Economies

Thematic Report By

**Vishal Manoria**
Senior Research Analyst

# CHINA'S ECONOMY IS IN TROUBLE

After three decades of extraordinary growth, the Chinese economy is undergoing a major transition from export and investment-driven growth to consumption and service-led sustainable growth.

This transition is accompanied by falling investments and imports, leading to a deceleration in global economic growth.

The spillovers to other economies may vary, as exporters of commodities are more affected than exporters of manufactured goods.

Although the Chinese government is committed to rebalancing the economy, a high investment-to-GDP ratio, declining trade, and the glut of money being pumped into its markets over the past year aren't exactly indicative of runaway success.

While the analyst community is still divided about an eventual hard landing, the country's staggered economic and trade growth, higher debt levels, and an evident meltdown of equity and property markets certainly suggest a more pronounced slowdown ahead. Either way, the situation would manifest itself globally through symptoms such as slower global trade, a drop in commodity prices, and other unmistakable financial contagion effects.

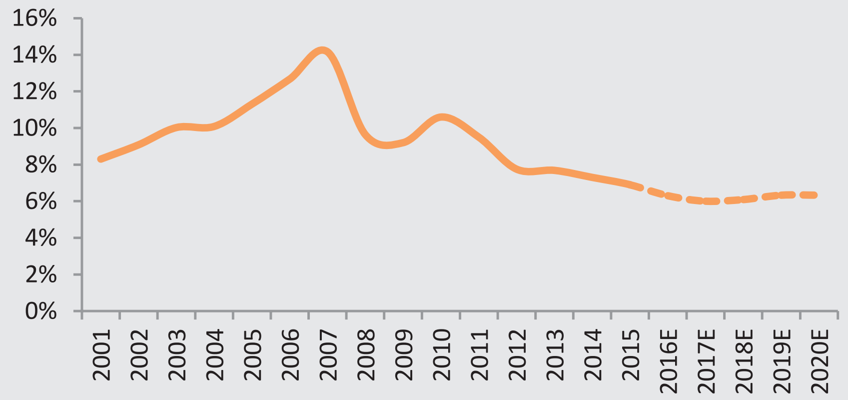
The world has already witnessed many of these symptoms.
They're only going to get worse if the ailing dragon doesn't regain its vigor.

## Growth in China Lurching

Markets have been extremely volatile over the past few months, and concerns about an economic slowdown in China have taken center stage. In addition to volatility in equity markets, the currencies of emerging markets have continued depreciating, with the Bloomberg Commodity Index hitting a 13-year low.

China registered a GDP growth of 6.9% in 2015, its lowest level since 1991.

**China's Real GDP Growth**



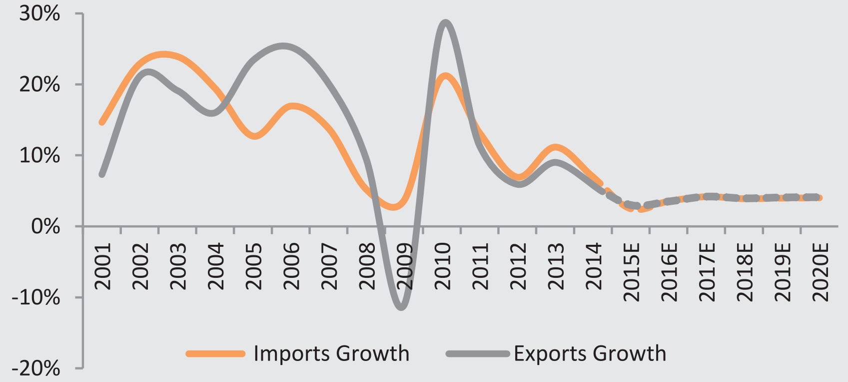

*Source: IMF*

The International Monetary Fund (IMF) has forecast a real GDP growth rate of below 7% over the next five years. China owes its economic slowdown to the manufacturing and property sectors. Real industrial output growth decelerated from double-digit figures in 2011 to 5.9% in December 2015, with investments declining 50%.

The investment-led slowdown is particularly severe in the property sector, which is significantly affecting the manufacturing and services sectors. Over-investment and construction have led to an oversupply of residential property units and a significant buildup in leverage. A sharp slowdown in growth has resulted in declining profitability and a pronounced lack of investment opportunity in such an excess capacity environment.

China registered robust growth in trade after it joined the World Trade Organization (WTO) in 2001. This growth decelerated over the past few years however, raising fears for the global economy and trading partners.

**China's Export and Import Growth**



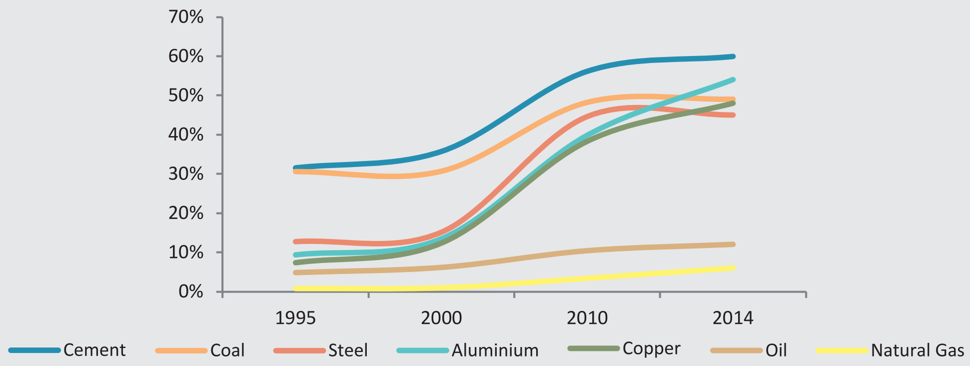

*Source: IMF*

# Commodity Price Movements and Spillovers

China has been a major driver of commodities demand over the past two decades.

China's demand now accounts for about half of the world's consumption of industrial metals, 12% of the world's oil consumption, and 23% of the world's gold consumption. China is also the largest importer of many agricultural commodities including soybean, cotton, and rice.

**China — Percentage of World Consumption**



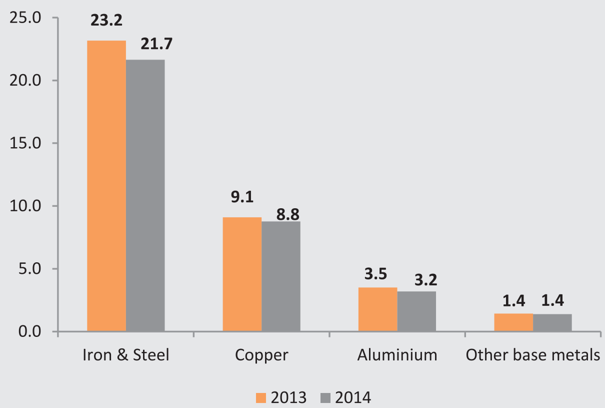

*Source: KKR Global Macro Trends Report, World Economic Forum*

Relentless investment in its export sector has led to China's large share in the global consumption. The country's current share in global industrial production is about 30%, up from 15% in 2008. As demand for commodities surged, producers ramped up production to meet demand. However, the recent economic slowdown has resulted in excess production capacity, leading to a significant fall in commodities prices.

With global demand likely to stay relatively weak, China is unlikely to continue its investment spending spree.

Its imports of industrial commodities have already declined, and a weaker Yuan could further reduce imports. Oversupply in China would add to the pressure on the market for metals, especially steel, coal, and aluminum.

**China — Commodities Imports (Million Tons)**




*Source: COMTRADE*

We expect China's consumption of industrial metals — especially those used in infrastructure developments — to gradually decline. However, a strong demand for soft commodities is expected on account of rising income levels of the middle-class and lower middle-class segments.

# Financial Contagions from a Chinese Slump

While the main spillover channels from China remain falling trade and commodities prices levels, growing financial linkage is another noteworthy risk.

According to the People's Bank of China, bonds worth CNY 22.3 trillion were issued in China over 2015, making it the third-largest bond market in the world after the US and Japan. Companies or financial institutions with a greater exposure to the Chinese market and its banking sectors would be affected by the country's slowdown.

Chinese companies are highly leveraged as they have increased their borrowings to keep up with increased investments. A high leverage ratio, along with a low profit level, could result in financial stress. According to S&P Ratings, at least six offshore and eight onshore Chinese corporate issuers missed payments on bond obligations in 2015. More such defaults could have an adverse impact on Asian economies. S&P Ratings expects corporate default rate to rise in 2016, potentially destabilizing financial markets. The IMF stated, "Direct financial spillovers include a possibly adverse impact on the asset quality of at least USD 800 billion of cross-border bank exposures."

The financial contagion risk is limited as China has a closed capital account and international banks have limited exposure to China. However, banks based in Hong Kong, Singapore, Taiwan, and the UK are significantly exposed to a potential downturn in China.

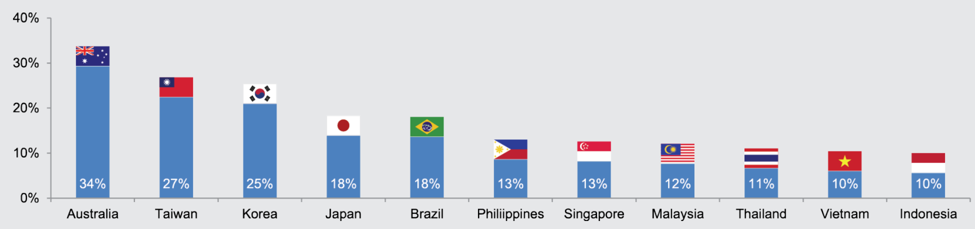
# China's Trade Influence and its Global Impact

Given the global economy's growing reliance on China, any instability there could pose a major risk to markets across the board.

China is the second-largest economy in the world and a major contributor to global economic growth. Moreover, it is the largest exporter, manufacturer, foreign exchange reserves holder, and second-largest importer in the world. China's growth lag and rebalancing efforts would severely impact trade volumes and commodity prices elsewhere.

The economic downturn in China would mostly affect commodities exporters that have strong trade ties with the country.

**Exports to China (Percentage of Total Exports in 2014)**




*Source: IMF DOTS*

Asian economies, especially South Korea and Taiwan, would be the hardest hit, and Japan is likely to experience a recession. Moreover, Australia and Brazil would be significantly affected by waning demand as well as falling investment flows and commodities prices.

In this report, we have highlighted how China's economic slowdown would affect other countries. We have considered direct exposure to China for this research. However, these economies could also be hit due to their indirect exposure to China, which could result in an even more severe outcome.

## Australia

With 34% of it's exports linked to China, Australia has significant exposure to Chinese demand.

Australia supplies coal, LNG, as well as iron ore and other base metals, which are heavily dependent on demand from China's housing and manufacturing sectors. In 2014, iron ore accounted for more than 60% of the total exports (or about 3.2% of GDP) of Australia.

China's economic slowdown, sluggish demand, and falling commodity prices are expected to dent Australia's GDP growth and currency values.

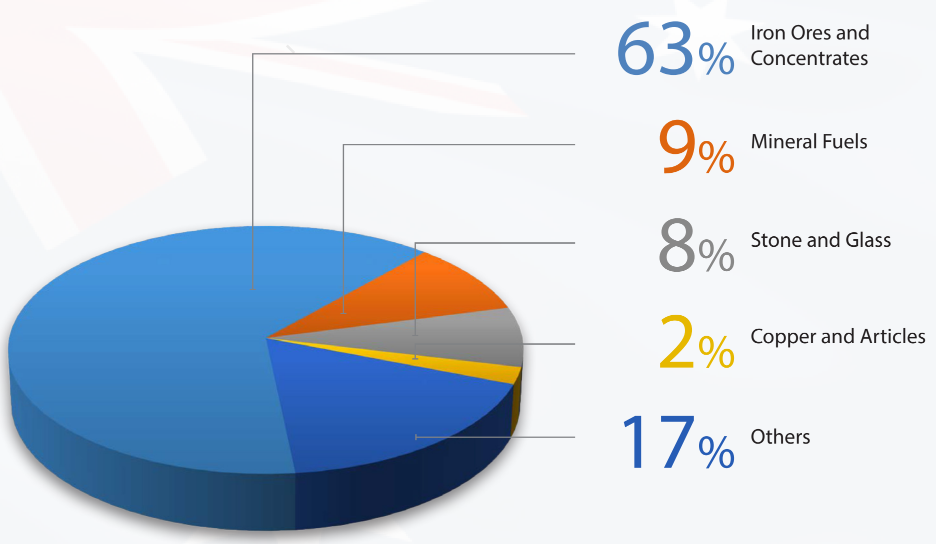
Iron-ore prices fell to a multi-year low and the Australian dollar plunged to a six-year low against the US dollar over concerns about the health of Chinese economy. Demand for iron ore is likely to drop, further weighing down the Australian economy.

Thermal coal prices declined, falling below $45 per ton, a significant drop from the $150 per ton price they commanded just four years ago. In recent years, Australian mining companies have ramped up production despite falling prices, which will further exacerbate the oversupply.

The Reserve Bank of Australia has recently cut its GDP growth forecast, pegging it between 2.0% and 3.0% for 2016.

As the export and investment dynamics in Australia remain negative in light of China's decelerating economic growth, the long-term impact of a collapse in commodities prices could lead to a decline in government spending, forcing small miners in Australia to shut down their operations.

**Composition of Export to China**




*Source: Market Analysis and Research, International Trade Centre*
*Note: Percentages may not add up to 100 due to rounding off*

## Taiwan

Taiwan's economy has high exposure to China's domestic demand. China is Taiwan's largest trading partner, accounting for 27% of Taiwan's exports. As demand declined, Taiwan's real GDP growth dropped to 0.85% in 2015, its lowest level since the 2009 global recession.

Taiwan exports consumer electrical and electronic equipment, precision instruments, machinery, chemicals, and industrial materials to China.

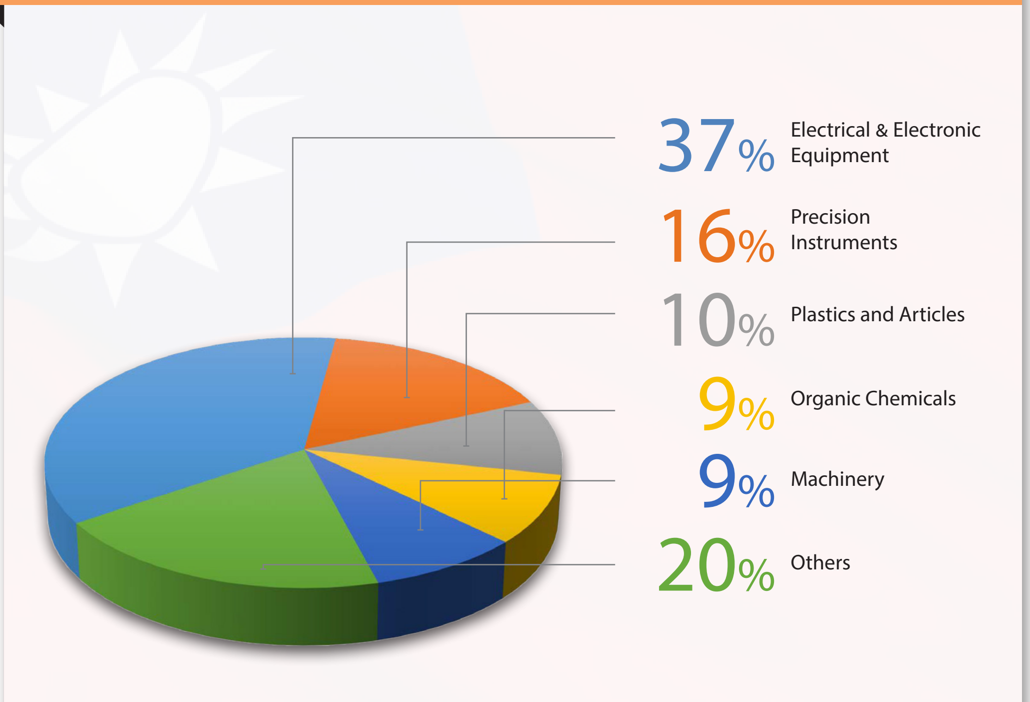
In 2014, these five product categories accounted for about 80% of the country's exports. Demand for machinery, chemicals, and industrial materials is highly vulnerable to the risk of a slowdown in China's fixed asset investment.

Falling demand from China has already started affecting growth in Taiwanese exports, with orders declining 12.3% YoY in December 2015, extending losses for the ninth consecutive month.

As many Taiwanese companies have production facilities base in China as well, Taiwan is also dependent on China for its outward-bound foreign direct investment (FDI).

Being overly dependent on the Chinese economy, Taiwan will be significantly affected by economic conditions in China.

**Composition of Export to China**




*Source: IMF DOTS*
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## South Korea

South Korea — an export-driven economy — has substantial trade and investment exposure to China, demand from whom accounts for more than one-fourth of South Korea's exports.

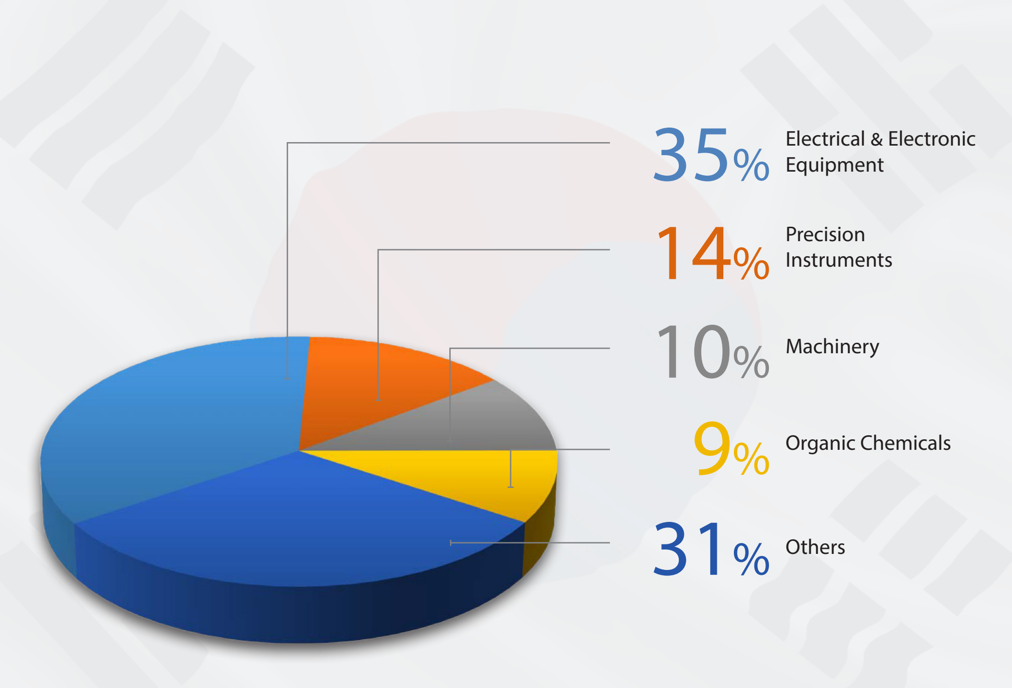
South Korea's exports fell 18.5% YoY in January 2016, its most significant decline since 2009, extending losses for the 13th consecutive month. Due to the increasing risks of a Chinese slowdown, the Bank of Korea has cut the nation's GDP growth forecast for 2016 to 3.0% from its previous estimate of 3.2%.

South Korea exports petrochemicals, iron and steel, LCDs, semiconductors, general machinery, and automobile parts to China.

While manufacturing activities remain sluggish and particularly vulnerable to weak growth in China, the economic slowdown would also have an adverse effect on South Korean capital equipment and industrial products. Low demand and overcapacity, especially in the electronics and automobiles industries, are likely to weigh on investment growth.

China has climbed higher in the manufacturing sector's value-added chain, and if it expands into high-tech industrial and telecom equipment as well, Korea's exports in these sectors will be affected over the long term.

**Composition of Export to China**




*Source: Market Analysis and Research, International Trade Centre*
*Note: Percentages may not add up to 100 due to rounding off*

## Japan

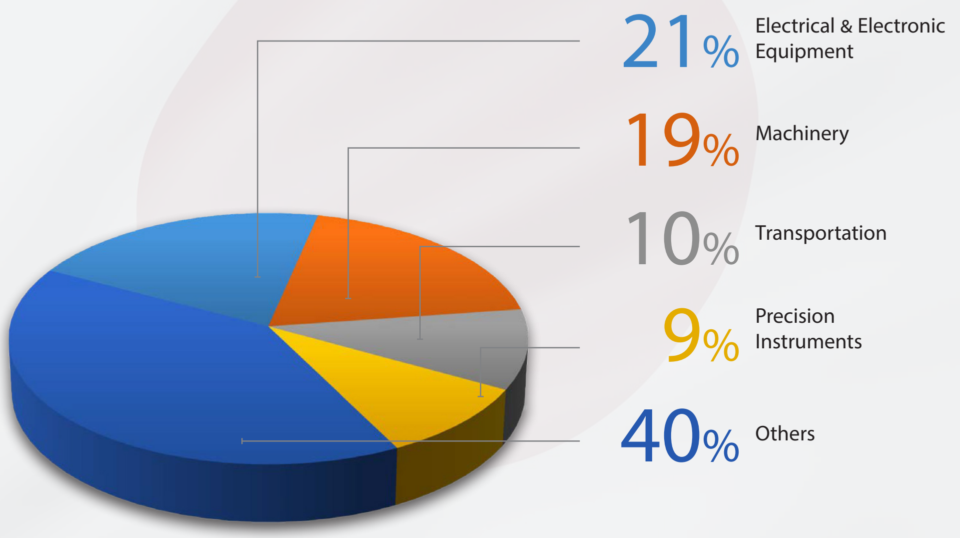
Accounting for nearly one-fifth of Japan's total exports, China is its second-largest export market.

China's share of Japan's total exports increased substantially over the years, exports that comprised primarily of electrical & electronic equipment, machinery, automobiles, medical instruments, and chemicals. A decline in China's economy would have serious repercussions, as most of Japan's exports rely heavily on Chinese demand.

Japan's economy contracted at an annualized rate 1.4% in the fourth quarter of 2015, recording negative real GDP growth five times in the last nine quarters. Exports to China declined 18% in January 2016, registering losses for the sixth consecutive month and indicating a slowdown in the world's second-largest economy.

Tepid global growth coupled with China's economic slowdown would lead to waning demand for Japanese exports. Additionally, weaker commodities prices would affect investments in infrastructure, reducing demand for Japanese machinery and construction equipment.

**Composition of Export to China**




*Source: Market Analysis and Research, International Trade Centre*
*Note: Percentages may not add up to 100 due to rounding off*

## Brazil

Growing substantially over the past decade, Chinese demand accounts for nearly 18% of Brazil's exports.

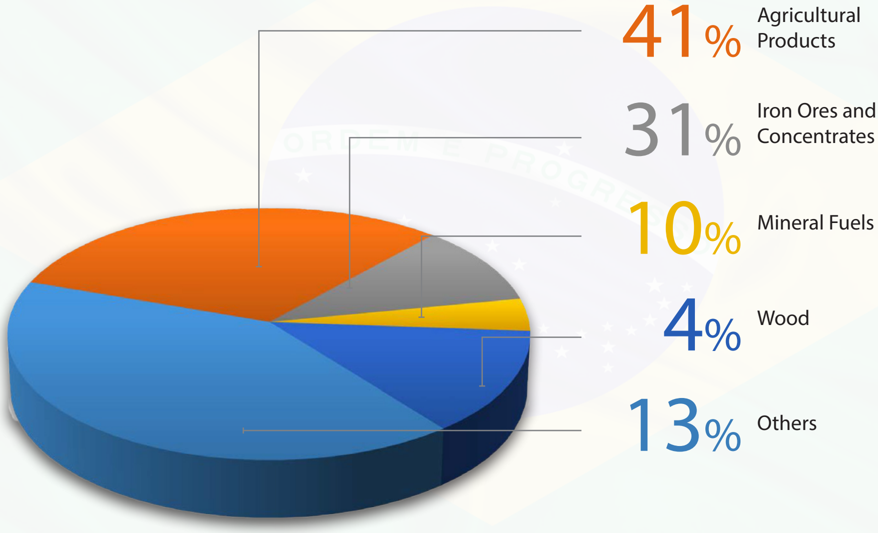
Brazil primarily exports iron ore, oil, soybeans, sugar, copper, wood pulp, and is among the top suppliers of commodities to China.

As the economic slowdown in China dragged commodity prices down, Brazil's economy followed suit, falling into a deep recession after reporting two consecutive quarters of declining growth.

Standard & Poor downgraded the country's debt to junk status after its currency hit an all-time low due to its staggering debt levels. The Brazilian central bank expects the country's GDP to contract by 3% in 2016.

The weakening commodity environment, a depreciating currency, and the structural slowdown in China are detrimental to the Brazilian economy, which is unlikely to recover soon.

**Composition of Export to China**




*Source: Market Analysis and Research, International Trade Centre*
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# CONCLUSION

The outlook for the global economy is bleak as export-driven economies weather the effects of a Chinese slump.

We believe a major manifestation of the Chinese slowdown would be declining trade, as evident from the diminishing export growth of countries that count China among their major markets.

Commodities prices worldwide are likely to stay low as well, and the waning demand from China would have an adverse effect on economies that are reliant on commodity exports.

International banks aren't critically exposed to China's ailing economy however, making the financial contagion effects likely to be contained.

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