

Economic & Investment Insight

China: the whys and wherefores

September 2015



Global stock markets lost more than \$5 trillion in the last two weeks following China's devaluation of the renminbi on August 11, and commodity prices fell on one measure to their lowest this century. On an economic level, the worldwide reaction was not surprising.

China now accounts for more than 15% of global activity and an even higher share of global growth – around 25%, on International Monetary Fund (IMF) calculations. Furthermore, China's response to its economic challenges has lacked clarity and, at times, faltered. This has created two uncertainties, which have played on the minds of market participants. First, have China's government and central bank lost control of their economy? And second, could events in China and their market fallout derail the gradual pick-up in global growth currently expected for 2016?

Economic Insight: Larger downside risks, but modest global pick-up remains in play

The sharp declines in global markets on, "Black Monday," (August 24), suggested that investors feared the worst. The following Tuesday's response – a partial market recovery that gained momentum following China's announcement of further monetary stimulus – could indicate that such fears have been overblown. In our view, institutional credibility has been damaged but not necessarily derailed; the story for the global growth outlook is similar. The downside risks have increased, but our core scenario – a modest pick-up in global growth momentum – remains in play. However, this will most likely occur with weaker near-term inflation pressures and extended policy stimulus.

The risks to our core scenario are threefold:

- 1. China's economic challenge should not be underestimated:** China's authorities have been attempting to clean up the legacy of past excesses without triggering a financial crisis; place the economy on a more sustainable, less investment-dependent path; and achieve this without derailing growth. On the latter point, while 2015 Q2 annual gross domestic product (GDP) growth may officially be 7.0%, our own activity indicator suggests the true number may be closer to 5.0%. More recently, falling sales of consumer goods, weak trade data and slowing industrial production growth all point to the potential for further slowdown ahead.
- 2. So far, the Chinese authorities' response may have made things worse, not better:** While an effective central bank uses policy to mitigate the negative effects of economic shocks – and really successful central bankers can walk on water, as Mario Draghi demonstrated with his 2012 pledge to do "whatever it takes" for the Eurozone – policy errors or perceived loss of influence can both increase the speed of transmission of negative risks and amplify their effects.
- 3. Worries over institutional effectiveness, combined with a backdrop of concerns over China's growth outlook, could transmit globally:** If confidence were sufficiently damaged to halt corporate spending, the pullback in investment could cause a vicious cycle of contracting sentiment and activity of the kind experienced in 2008. And if market moves were to create large enough losses to threaten the health of financial institutions, the rapid transmission of stress could also echo that of 2008.

So what supports our core scenario? First, it is worth noting that this core global scenario has incorporated below-consensus views on China for some time. Even before the latest developments, our most recent forecasts (Economic Insight, August 2015) pointed to a slowing of GDP growth from a below-target 6.6% this year to 5.9% next and 5.7% in 2017, reflecting our concerns about the authorities' ability to engineer a "soft" landing while rebalancing towards consumption-led growth. We had also cut our longer-term forecasts to reflect both the impact of high debt levels and diminishing returns to investment on China's potential growth rate.

Our core scenario assumes that, despite the ongoing challenges, **four key global stabilizers dominate the downside risks:**

- 1. Markets' worst fears about "currency wars" are most likely overdone:** As our August 2015 Monthly Economic Insight argues (Five questions and answers on China's FX move), a 10% depreciation of the renminbi on a 12-month horizon is a plausible scenario, allowing China to regain some export competitiveness without threatening its prospects for joining the International Monetary Fund's (IMF's) Special Drawing Rights currency basket or creating an ultimately self-defeating downturn in global activity.
- 2. Global financial institutions should be less prone to the transmission of financial stress than in 2008:** This reflects the subsequent introduction of stress tests and improved capital buffers.
- 3. Decreases in oil and other commodity prices act as a tax break for consumers and a cost mitigator for firms:** In the case of the Eurozone, for example, this could help offset the threat to regional growth from currency appreciation.
- 4. Central banks take credible and effective action:** This applies not only to China itself – which has much to prove after recent events, and may have to undertake a far more comprehensive package than this week's announcements – but also to other central banks. The U.S. Federal Reserve (Fed) will provide an early test: given the strength of its domestic economy, it had been considering raising rates in September, but that move could well be pushed back.

Investment Insight: Much to think about

This has obviously been a painful time for investors, with most large equity markets down around 10% month-to-date as of August 27. Commodities have seen continued weakness, with Brent crude down 15% in August alone, and copper and aluminum both down over 5% in the same period. Some currencies that are seen as having more exposure to recent developments have also fallen significantly, with the Malaysian ringgit and Russian ruble down around 10% and the Kazakhstani tenge down by over a quarter.

The catalyst for these sharp market falls has been the devaluation of the Chinese renminbi. This is an important event and a significant departure by Chinese policymakers. The reasons for this change of policy are many, but one of the main factors is the slowing Chinese economy. This is an economy that exists in a world where the Fed appears willing to accept a rising dollar, but where many other central banks have adopted policies resulting in the devaluation of their currencies. This combination is problematic to the Chinese export sector, and therefore to economic growth.

It would seem likely that the implications of this change in Chinese policy, and the likely path and efficacy of future policy, will remain at the forefront for investors for some time. This also comes at a time when investors are contending with the end of quantitative easing in the United States and the accompanying prospects for higher interest rates. This combination may see the current increased levels of volatility continue.

However, we should remember that there are benign impacts of recent developments. Falling commodity prices are unhelpful to those countries or companies that produce them, but in aggregate they should be helpful to the consumers of these commodities and to global growth. It would also seem likely that the deflationary implications of Chinese policy will result in policymakers elsewhere having little need to worry about inflation any time soon, with helpful implications for the path of future interest rates. In this regard, we should remember also that U.S. and UK economies are growing steadily and that there is real evidence of a pick-up in the Eurozone economy. With global growth still expected to be around 3% this year, we believe there is still plenty of opportunity for revenue and profit growth which can fund dividends and interest payments to satisfy both equity and debt holders.

There is clearly still much to think about. We will continue to monitor developments carefully and look to take advantage of opportunities where appropriate.

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