Special Report

Euro area: What are the risks from a slowing Chinese economy?

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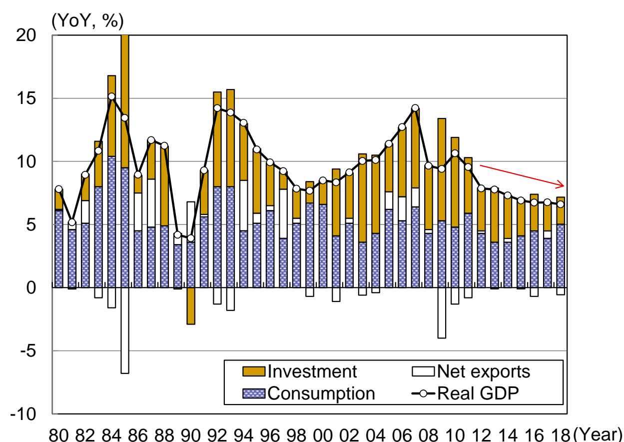
1. Introduction

Signs of weakness in various Chinese economic indicators have raised concerns about the health of the world's second largest economy. The IMF said that "growth in China may surprise on the downside" in its April outlook. For the euro area, any slowdown in an economy that contributes around a third to global GDP growth is unlikely to be good news. The ECB has suggested that "a slowdown in China" is already a factor behind weaker growth momentum in the euro area itself. In this report, we consider the links between Europe and China, and how a weakening Chinese economy might affect the euro area growth outlook.

2. The outlook for the Chinese economy

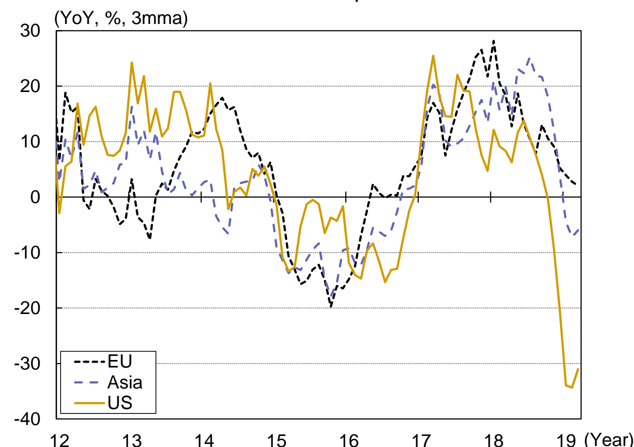
The Chinese economy decelerated for the third consecutive quarter in Q4 2018, but slower growth by itself is not unexpected or necessarily a cause for concern. The Xi administration has undertaken measures to reduce excess debt in recent years as it seeks a smoother, more sustainable growth profile and a rebalancing of the economy away from investment and towards consumption (Chart 1). After real GDP growth of 6.6% in 2018, the government's growth target for 2019 is between 6.0 and 6.5%.

Chart 1: China Real GDP Growth and Contributions



Source: China NBS, MUFG Bank Economic Research Office

Chart 2: Value of Imports to China



Source: China GAC, MUFG Bank Economic Research Office

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However, while slower GDP growth seems likely in the future, weakness in various indicators such as new car sales suggests there could be a more significant deterioration in economic activity amid uncertainty over heightened US-China trade friction. In response, the Xi administration has implemented widespread tax cuts and reinvigorated infrastructure investments, and the People's Bank of China (PBoC) is providing additional monetary policy support. Given the resilient income and employment environment, we believe that private consumption will most likely avoid a sharp slowdown.[1] At any rate, it seems likely that the Chinese government has enough firepower left in its toolbox of monetary and fiscal policies to support growth. We expect real GDP growth of 6.2% YoY in 2019, but we will continue to monitor the economy and the government's policies closely.

[1] See here: www.bk.mufg.jp/report/ecoasia2019e/outlook_asia20190228e.pdf

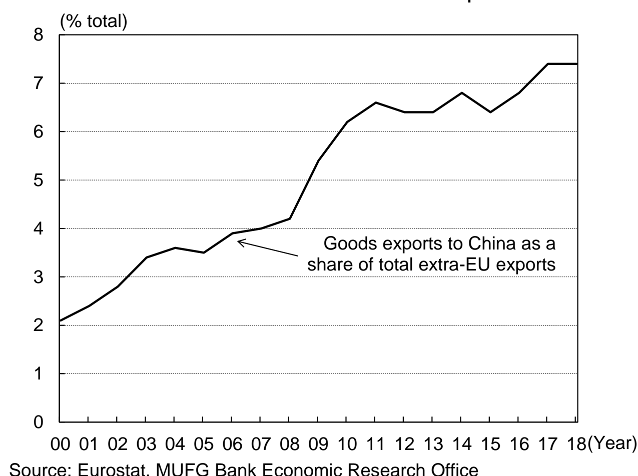
From a European perspective though, the slump in Chinese demand for imports (Chart 2) is concerning. While not as dramatic as from the US, import growth from the EU and Asia has weakened noticeably. This likely reflects increasingly interconnected international supply chains but does also raise concerns about the possibility of a shift to fundamentally lower Chinese demand. Any such slowdown in China would be particularly worrying given already-muted euro area economic activity.

3. Euro area exposure to China

(1) Goods trade

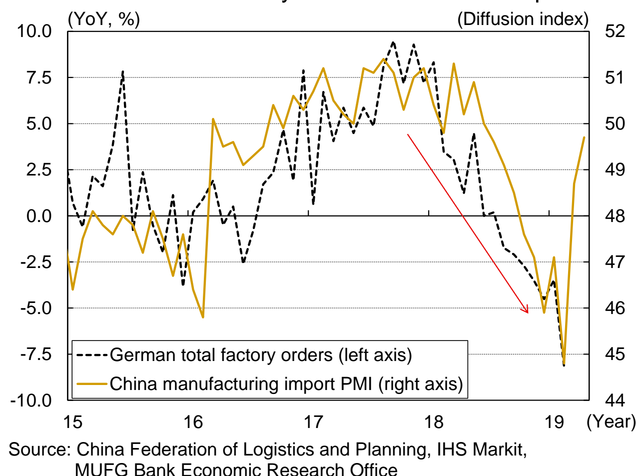
Trade with China has become increasingly important for the euro area. In 2000, China was the euro area's sixth largest partner for total trade (both imports and exports). By 2018, it was second only to the US. Euro area countries import a large amount of Chinese goods – but China also represents an increasingly significant source of external demand (Chart 3). Now, only the US and the UK import more from the euro area, and total euro area exports to China averaged 1.5% of GDP in 2018. With these key trade ties, it is not surprising to see a correlation between the China manufacturing import PMI and indicators such as German factory orders (Chart 4). While not necessarily linked, both have fallen sharply since mid-2018 as global growth momentum has continued to ease. For the euro area, the slowdown has been especially apparent in the manufacturing sector.

Chart 3: China Share of EU Exports



Source: Eurostat, MUFG Bank Economic Research Office

Chart 4: German Factory Orders and China Import PMI



Source: China Federation of Logistics and Planning, IHS Markit, MUFG Bank Economic Research Office

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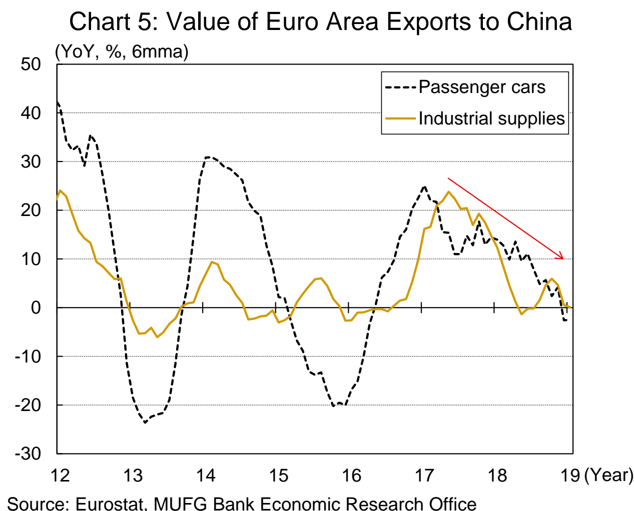
Manufactured goods, machinery and transport equipment accounted for 58% of total euro area exports to China in 2018 (this includes road vehicles which comprise 17% of total exports to China, up from 6% in 2000). Chemicals and related products are also important (13% of the total). Further examination of euro area exports to China largely reflects two particular sources of demand: raw materials or intermediate goods, and luxury consumer goods. We include European cars in the latter, and note that Germany alone exported 250,000 passenger cars to China in 2017. Recent data on nominal euro area export growth to China, which has slowed since a peak in 2017, suggest there may be weakness in both categories (Chart 5). Growth in the export of cars has slowed, and more granular data shows that exports of 'small ticket' luxury goods have also declined between 2017 and 2018 (e.g. sparkling wine, which fell by 6.9% YoY). Meanwhile, there are also signs of weakness in the exports of intermediate goods and raw materials which may be used to manufacture other items in China for domestic consumption or export. Exports of industrial supplies have slowed since mid-2017, as those of plastics fell by 3.7% between 2017 and 2018, iron and steel by 1.1%.

Of the euro area member states, it is Germany that is most exposed to China with exports to the country worth 2.5% of GDP (Chart 6). Belgium and the Netherlands also trade quite heavily with China, although this likely reflects to some extent the fact that many goods are shipped from these countries in transit from other euro area member states.[2] Spain is the least exposed major euro area country with exports to China worth just 0.45% of GDP.

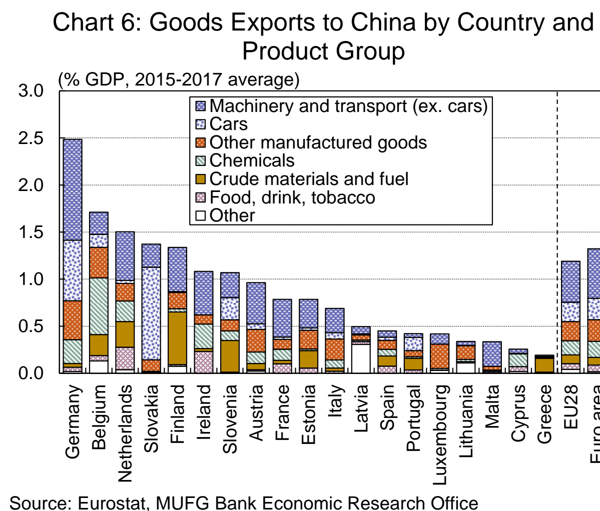
[2] An issue we have mentioned previously here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20181211.pdf

Chart 5: Value of Euro Area Exports to China



Source: Eurostat, MUFG Bank Economic Research Office

Chart 6: Goods Exports to China by Country and Product Group



Source: Eurostat, MUFG Bank Economic Research Office

(2) Services trade

The EU is the largest exporter of services in the world in nominal terms, ahead of the US. However, China accounts for just 4.5% of extra-EU service exports. Within this, the largest category of service exports is transport (accounting for around 35% of total service exports to China). This category includes air and sea freight, and would therefore be vulnerable to a slowdown in Chinese demand for European goods. Travel service exports (in other words, Chinese visitors to Europe) are also important, at around 10% of total service exports to China, so any domestic headwinds for Chinese consumers would likely also be a drag for the European tourism industry. Otherwise, European service firms have found it difficult to access the Chinese market due to its restrictive policies (such as the requirement for joint ventures

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with local businesses), low competitiveness due to subsidies for Chinese firms and the weak enforcement of intellectual property rights. Accordingly, exports of other services from the euro area to China, such as information services and insurance, are relatively low.

(3) Financial services links

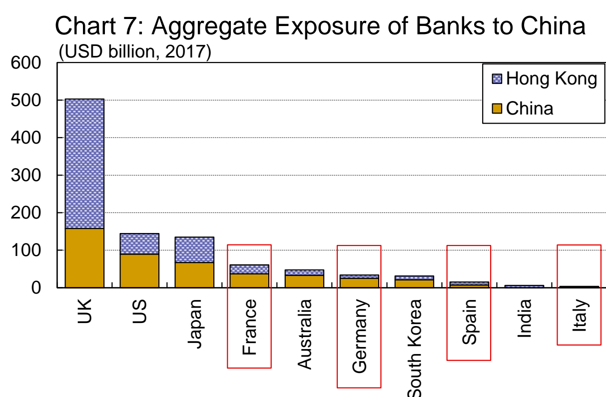
Despite the size of its economy, China is not especially integrated into the global financial system and there is little external participation in China's domestic markets. Foreign investors hold around 2.4% of total Chinese equity market capitalisation and just 1.6% of the total value of bonds outstanding. In terms of European banking links, UK institutions are most vulnerable because of the country's orientation towards financial services and historical links with Hong Kong. Euro area banks are relatively unexposed (Chart 7) so direct financial losses from any China slowdown would likely be limited. However, depending on the shape and form of a shock to Chinese growth, there would likely be contagion to western financial markets from weaker investor confidence. Chinese stock market turbulence in late 2015-early 2016 provides something of a guide: at the time, fears over China's economy prompted sharp sell-offs in European equities.

(4) Chinese investment in Europe

Chinese foreign direct investment (FDI) in Europe had been increasing until 2016 (Chart 8). Since then, and despite strong state-owned investment in 2017 in particular, there have been signs of lower outward Chinese investment to Europe (and globally) as the Xi administration has increased restrictions to prevent yuan-weakening capital outflows. On top of this, pressure on Chinese firms to reduce leverage has also prompted some sales of overseas assets. That said, US-China tensions may mean that Europe becomes relatively more attractive for any continued Chinese outward investment. We note that the Italian government has recently endorsed the Chinese government's 'Belt and Road Initiative' of infrastructure development which may pave the way to Chinese infrastructure investment in Italy.

However, there is increasing opposition to Chinese investment in many European countries. The EU parliament voted in February to increase the scrutiny on foreign investment in sectors which could pose threats to European interests in "critical sectors" (such as infrastructure and defence). Additional measures had already been announced by national governments in countries such as France and Germany.

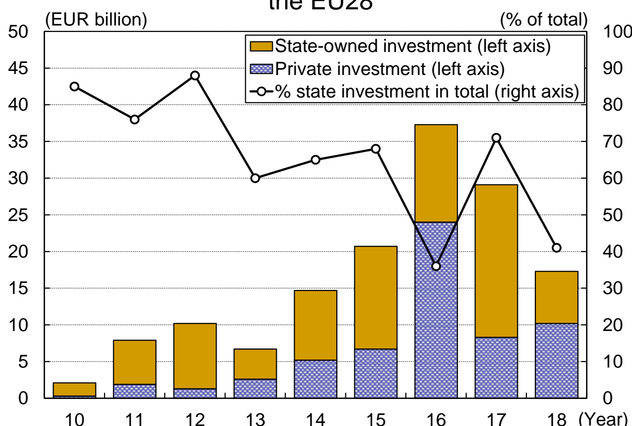
Chart 7: Aggregate Exposure of Banks to China



Note: Chart shows consolidated foreign claims of each country's banking system, on ultimate risk basis, on all residents of China. This includes loans, deposits placed, holdings of debt securities, equities and other on-balance sheet items.

Source: BIS, MUFG Bank Economic Research Office

Chart 8: Chinese Outward Foreign Direct Investment in the EU28



Source: MERICS, Rhodium Group, MUFG Bank Economic Research Office

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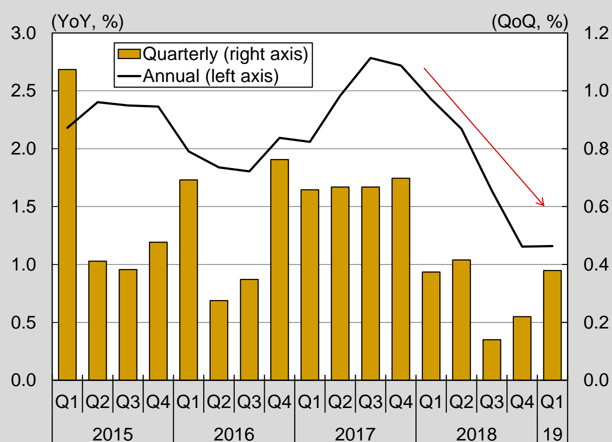
Box 1: The recent euro area soft patch and China

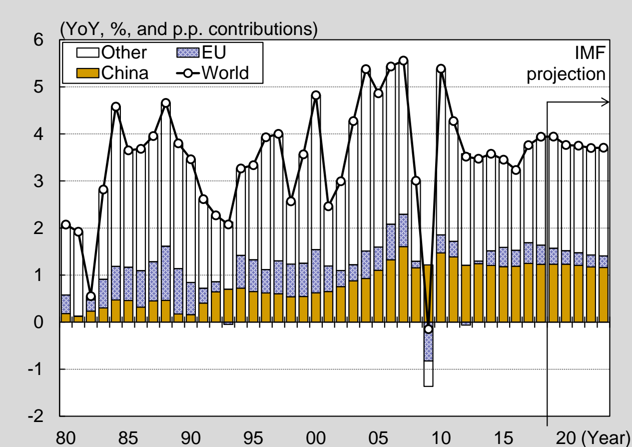
Euro area GDP growth has slowed from 2.7% YoY in the second half of 2017 to just 1.2% YoY over the past 6 months (Chart A). There is a long list of factors behind this soft patch. These include the tariff battle between the US and China (and the threat of further escalation), new car industry regulation, the risk of 'no deal Brexit', the end of the ECB's net asset purchases, as well as the low level of the Rhine river which hampered barge access to Europe's industrial heartland. Slightly slower growth in China may not seem so consequential given this long list of headwinds and the relatively small trade channel detailed above in Section 3, but given China's status as a key driver of global growth (Chart B), we are reluctant to dismiss it as a factor.

Chart A: Euro Area Real GDP Growth



Source: Eurostat, MUFG Bank Economic Research Office

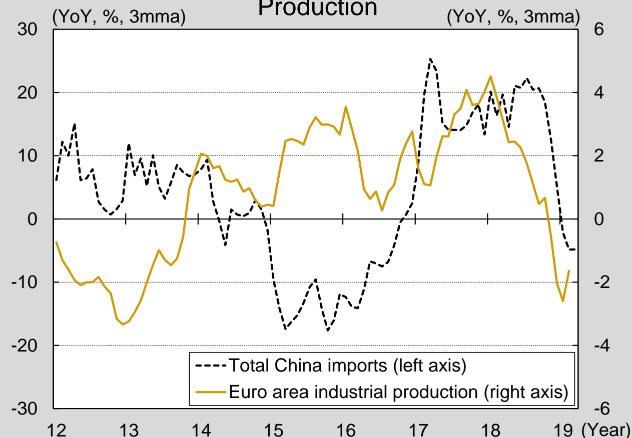
Chart B: Contributions to World GDP Growth



Source: IMF, MUFG Bank Economic Research Office

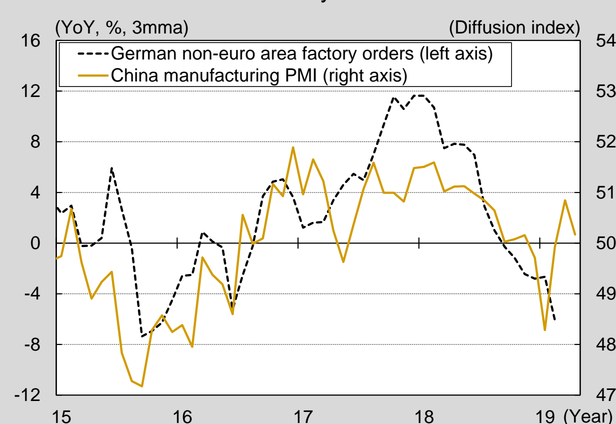
However, it is hard to disentangle to what degree weaker Chinese activity growth has affected the euro area. As Chart C shows, there is not an obvious link between euro area industrial production and Chinese import growth (in fact, the recent slump in euro area industry seems to have come first). But there is some sector-specific evidence as German non-euro area factory orders do closely follow the Chinese manufacturing PMI, which we use as a proxy for overall Chinese activity (Chart D). In particular, we suspect the clear slide in Chinese new car sales from September 2017 to February 2019 reinforced the headwinds facing the German economy, both directly through lower export sales and indirectly through confidence channels.

Chart C: China Imports and Euro Area Industrial Production



Source: China GAC, Eurostat, MUFG Bank Economic Research Office

Chart D: German Factory Orders and China PMI



Source: German Federal Statistics Office, IHS Markit, MUFG Bank Economic Research Office

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4. The risks for the euro area from a China slowdown

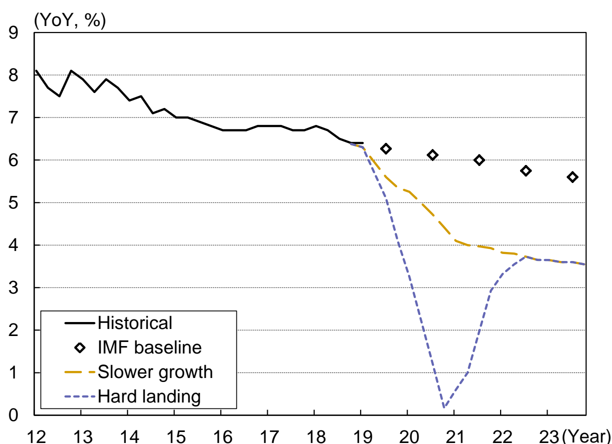
(1) Scenarios and model output

Most forecasters expect slower Chinese growth over the medium term, including the IMF, which projects real GDP growth will fall from 6.3% YoY in 2019 to 5.6% by 2023. Such a gradual deceleration is unlikely to shock the euro area economy. But, as discussed above, there are concerns about a more serious slowdown. To estimate the risks for the euro area, we consider two scenarios (Chart 9):

- '**Slower growth**': a deceleration to around 3.5% YoY in 2023 (roughly a 2pp shock to most current GDP growth forecasts).
- '**Hard landing**': growth falling very sharply through 2019 and into 2020 before recovering to the 'slower growth' path.

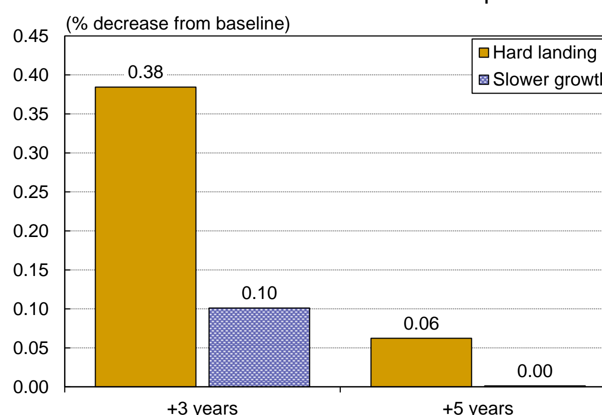
We use the Oxford Economic model to estimate how such Chinese growth profiles might affect the euro area economy. In both scenarios, the drag on the euro area economy peaks after three years from the start of the application of the shock (Chart 10). In the worst case 'hard landing' scenario, the level of euro area GDP is reduced by 0.4% compared to the IMF baseline.

Chart 9: Illustrative China Growth Scenarios



Source: China NBS, MUFG Bank Economic Research Office

Chart 10: Euro Area Real GDP Responses



Source: IMF, China NBS, Oxford Economic Model, MUFG Bank Economic Research Office

We note that these figures are lower than might be expected. In fact, the ECB published similar analysis at the start of 2018.[3] It used four different global macro models to estimate how a "swift rebalancing" of the Chinese economy (which is closest to our 'slower growth' scenario, but more benign) would affect other economies. Of those four, the Oxford Economic model, which we use above, consistently estimated the smallest negative drag. For the euro area, the model estimated around -0.05% deviation from the baseline scenario after three years (compared to around -0.25% when using the ECB-Global model).

[3] See '*The transition of China to sustainable growth*' here: www.ecb.europa.eu/pub/pdf/scpops/ecb.op206.en.pdf

The model we use may well underestimate the risks but the output is still useful to understand the channels through which the euro area would be affected by a China slowdown. Initially, there would be strong drag on euro area exports from reduced Chinese demand in each

scenario. It would therefore be export-orientated euro area member states such as Germany and the Netherlands that would be most affected. The headwind for these economies would likely endure for some time but, interestingly, the model output suggests that the effect of slower Chinese growth is negligible after five years for the euro area as a whole. The drag is relatively small even after a 'hard landing' scenario. This is because there would be support from a decline in commodity prices once the initial shock fades. The ECB has estimated that a 1% decline in Chinese GDP growth could cause oil prices to fall by around 5% after two years. This would not harm any euro area economies (Norway and the UK, both non-euro countries, are Western Europe's main oil producers). However, lower commodity prices, especially fuel, would support consumer spending. Countries that export relatively little to China but import plenty of commodities (e.g. Spain) would likely benefit most.

(2) Sources of uncertainty

There are some other uncertainties which may not be captured in straightforward modelling. First, and most broadly, the risk for global production chains is unclear. Complicated global supply chains may disguise the full extent of China's role in generating final demand. Exports from the euro area to third party economies such as the US, UK, Japan or Korea may then be reprocessed for export to China. On the other hand, there are also euro area exports of intermediate goods that are processed in China before being exported elsewhere. These may not be affected by a slowdown in Chinese domestic demand, so gross trade flows should be interpreted with some caution. The ECB has estimated that "at least 8% of euro area exports to China are not directly linked to developments there, but rather reflect demand developments elsewhere".

Second, we would expect a swift and firm response from Chinese authorities to cushion growth, but the effect on economies in the rest of the world would depend on the exact form of any measures. Most important would likely be any policies that affect the exchange rate. The Chinese authorities have substantial firepower to defend the yuan with foreign reserves of around three trillion USD (over 20% of GDP). Tighter capital controls would also help to support the currency from higher outflows. If, on the other hand, the Chinese authorities allow the yuan to depreciate – perhaps to boost China's external competitiveness – then euro area exports of similar goods to the rest of the world would in turn become less competitive. From a European policy perspective, a Chinese growth shock would make it harder for the ECB to normalise interest rates, and could even increase the likelihood of extra stimulus. A longer period of accommodative policy would support euro area economic activity (but increase the risk of imbalances further down the line).

Lastly, it is not easy to predict the effect of a China slowdown on global confidence. As discussed, the relatively small links between China and the global financial system may limit the contagion. But the risk of a 'China hard landing' has featured prominently in investor risk surveys for many years so it seems unlikely that such a prospect would be dismissed lightly. Initially, other emerging market economies may suffer (as was the case in 2015-2016), especially those that are reliant on commodity exports. For developed markets, the overseas shock would be amplified if Chinese investors feel pressured to liquidate overseas assets (property markets in major cities may be especially vulnerable). Any negative effect on the UK

financial system, which has closer links to China, may also have spill-over effects on the euro area economy.

5. Conclusion

Chinese growth has been gradually slowing in recent years as the economy rebalances away from investment and manufacturing and towards private consumption and services (and trade friction with the US provides additional challenges). This gradual slowing is likely to continue but the recent weakness in some economic indicators has prompted concerns that a slowdown could be deeper than expected. In response, the Chinese authorities have implemented various fiscal and monetary policy measures to support economic activity. Recently, there have been some more encouraging signs with clear improvement visible in both the ‘official’ and the Caixin manufacturing PMIs for March (as shown above in Chart 4, for example). However, risks remain and while recent trade talks between the US and China have seemed constructive, any increase in friction could cause economic conditions to deteriorate.

A faster-than-expected slowing of the Chinese economy would affect euro area output. The most direct channel would be a reduction in demand for goods exports (cars and manufactured goods would be especially vulnerable). However, we find that some of the drag would be offset further ahead as euro area consumers benefit from lower commodity prices. The indirect risks are harder to estimate. A flight to safety response might increase outward investment to Europe, but the Chinese authorities would likely put in place measures to limit this and reduce the downward pressure on the yuan. Meanwhile, the euro area has relatively small direct financial links to China. However, a sharp downturn would likely precipitate a confidence shock which could affect markets around the world.

It would be unwise to ignore these risks, even if there is an improvement in China’s short-term indicators. The IMF has noted that the Chinese government’s recent stimulus to support growth may “heighten financial vulnerabilities, reduce future policy space, and raise downside risks to medium-term growth”. Meanwhile, there is still substantial scope for China to integrate further into the global financial system, which would only amplify any eventual shock from a China hard landing for Europe and the rest of the world.

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