China will not cause a crash

by Michael Heise

Signs of a slowdown in China have been rattling stock markets of late. China is important, a hard landing of its economy, which absorbs some 10% of global merchandise imports, would hurt. But will the middle kingdom drag the global economy into recession? That seems unlikely. The US consumer is once again riding to the rescue. Consumption there well exceeds Chinese dimensions. And the USA absorbs substantially more German or European goods than China does. And growth in demand within Europe now also provides a further counterweight to the slowdown in China. Peripheral countries such as Spain, Portugal or Ireland are set to see strong growth in consumption and investment in 2015, in Italy and France the increase is still subdued but unmistakable. Both here, as well as in Germany and the UK, high purchasing power stability, not least due to the drop in oil prices, is a key factor. Europe is gradually returning to self-sustained growth.

As things stand, China would have to experience a full-blown crash to trigger a global recession. That also looks unlikely. We need to recognize that Chinese industry is currently undergoing a major and doubtless necessary downward correction, having for many years swiftly built up capacity that it now cannot use. German industrial sectors are reporting falls in good exports to China and a drop in sales at their factories on location. It should not be overlooked that in China, too, the tertiary sector is now bigger than industry. And in trade and services things still seem to be ticking over nicely. Retail sales are growing at double-digit rates, internet companies such as Alibaba, Baidu or Tencent are reporting ongoing sales and earnings growth, demand for insurance and banking services continues to pick up. Of course, the services sector in China will also not be able to divorce itself entirely from industry. But a structural shift is under way, allowing the third sector to grow faster than the second. It is pivotal for the country that consumer demand, which is increasingly geared to services, remains robust. And, so far, that is still the case. With prices largely stable and wages still rising strongly, the purchasing power of Chinese consumers is growing at an impressive pace.

The biggest risk to the Chinese economy comes from the over-indebtedness of municipalities and state-owned enterprises. The Chinese government’s ample reserves provide leeway to prop up state-owned enterprises and avert large-scale bankruptcies, but this means that the money available does not go towards new, competitive companies. Newcomer rivals frequently have to rely on the shadow credit market. That is not only a competitive disadvantage for them but also a risk for financial market stability.