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CHINA

China will not drag down the world economy

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Investor panic express fears of a general slowdown in the world economy. The immediate reason are signs of weakness in emerging markets, most notably China. These fears are exaggerated, however. The news from China is not all bad. And even if more negative news come in, the Chinese government will step in to avoid a hard landing. In the short term, therefore, there is no reason for panic. In the long term, however, China's challenges remain huge.

The current panic in financial markets shows that investors are increasingly concerned about developments in the world economy. The immediate trigger are signs of weakness in emerging markets such as Russia, Brazil, and especially China. Brazil and Russia are suffering from a renewed fall in oil and commodities prices and are therefore unlikely to recover quickly. On the other hand, lower commodities prices are good for growth in China and most other Asian economies as well as the industrialized countries.

If we look specifically at the collapse of equity prices in China, we seem to see worries not only an end to the „China boom" but about an impending economic recession. Drastic daily fluctuations show the extent of nervousness, even panic, among investors. There are, however, good reasons to believe that these market movements are exaggerated – the risks and structural problems that the Chinese authorities are faced with notwithstanding:

1) One reason for concern is the weakness in foreign trade since the beginning of the year. In the first seven months of 2015, goods exports were slightly below their year-earlier level. For China, which has become used to explosive growth rates in recent years, this is a big change. Other Asian countries,

however, are experiencing a similar slowdown, most notably Japan. Two trends could be behind these data: first, the slowdown in intra-Asian trade, which is likely being substituted for by foreign direct investment and local production by international companies. Second, export prices have hardly risen recently, which puts a dampener export earnings.

That does not mean, however, that trade balances are worsening. On the contrary, surpluses in China and other Asian economies will be boosted by falling import prices. The slight devaluation of the renminbi should further help Chinese competitiveness and support export growth.

2) Private consumption has been playing a more important role in Chinese growth in recent quarters. The latest retail data indicate stable growth. Here, too, lower oil prices, and thus lower inflation, will have a positive influence.

3) Prices for new-built residential real estate have stabilized after the falls of May 2014-Apil 2015, and they are now showing signs of gradual recovery. Low interest rates will help stabilize this market going forward. They will also facilitate investment in the corporate sector, even though existing overcapacity will continue to constrain investment activity in several sectors.

4) Industrial growth in China has slowed noticeably in recent quarters. But here, too, there are signs of stabilization. Industrial production is about 6% higher than a year earlier. It has remained at this level for two quarters now. Falling commodities prices should support a recovery in industrial production.

The news from China, therefore, is not all bleak. If signs of weakness persist nonetheless, the Chinese leadership will take steps to reduce uncertainty among consumers, corporates and especially investors. Most likely, it will effect an orderly devaluation of the renminbi, following the devaluations of several of China's trading partners. This would amount to a correction of previous overvaluation, not the start of a currency war. It is also possible that the Chinese government will announce another state-led investment program, even though that would run contrary to its objective of move towards a more balanced and consumption-oriented economic model.

In any case, China will do everything possible to avoid a hard landing. In the short term, there are no grounds for excessive concern. In the long term, China's structural challenges remain formidable. China will have to rebalance its economy away from investment and towards consumption, find an economic model that is socially and environmentally sustainable and reduce regional and income inequalities. These challenges will keep China busy for decades but they cannot justify sudden panic in financial markets.