FONDATION ROBERT SCHUMAN

POLICY PAPER

European issues
n°376
22th December 2015

The impact of China's economic situation on Europe

Karine Lisbonne de Vergeron

Abstract :

The collapse of the Shanghai stock market at the end of August (a downward correction of 37% since 12th June) has brought back to the fore the inherent weaknesses in China's current economic development. The country's decreasing growth to 7% over the first six months of the year (with an annual forecast of 6.7% for 2015 according to the OECD), thereby falling to its lowest level since 2009, is indeed a source of concern with regards to its impact on global growth as well as its short and midterm consequences for China's main trading partners, primarily the European Union, the United States and Asia. Some observers believe that the country might even fall into recession if its GDP growth were to drop down to 3% or 4% [1]. Others envisage a crisis scenario, pointing out a loss of credibility of the Chinese government and expressing real doubts over its ability to engage into fully effective measures to successfully manage the country's vital economic transition, including reforming notably state-owned enterprises. But the Chinese economy still retains many assets favourable to managing the necessary transition towards greater consumption as well as promoting future growth. This is further supported by significant foreign exchange reserves despite recent capital outflows. It remains, nevertheless, that China's image has changed and that every forecast now inevitably points towards a long-term slowdown of the Chinese economy. So the question arises: With what impact and consequences for Europe?

1. TOWARDS A "SOFT LANDING" OF THE CHINESE ECONOMY?

China's rise over the last 35 years is certainly an unprecedented phenomenon both by its degree and scale. The country totalled 2.1% of the world economy in 1994, but 12.8% in 2014. This ascension has enabled it to become the second largest economy in the world in nominal GDP since 2010 (third if we include the EU and 30% below that of the Eurozone's). But the country is now facing a necessary landing of its economy characterised, on the one hand, by a continuous decline of 6.9% year-on-year of its exports and imports for the first six months of 2015 (with a further decline of 6.9% in exports in October despite an approximate 4% devaluation of the renminbi [2]); and, on the other hand, by a slowing in investments. This phenomenon is also coupled with a loss in competitiveness triggered by rising production, notably higher labour, costs and an increasingly ageing population (the hourly manufacturing wage has increased by 12% on average since 2001), and, therefore, lower gains in productivity. But there is also a considerable problem of overcapacity in a number of industrial sectors, such as in the steel, cement, aluminium and ship-building industries, which can go up to 50% of production capacities, as well as a high level of debts. Total debt in the country was estimated at 282% of GDP in mid-2014, i.e. four times that of 2007 [3].

China now has to address several core issues to rebalance the structure of its economy so as to guarantee a growth rate sufficient to maintain social stability. This is even more the case since the current situation does not simply stem from cyclical economic weaknesses nor from a sudden crisis but represents a structural and lasting slowdown of its

*1. Willem Buiter, **Is China leading the world into recession?**, Citigroup, 8 September 2015. Others believe that China's real GDP growth would already stand well below, at around 2% (Le Point, 25 September 2015).*

2. Between mid-August and the end of September.

3. Debt and (not much) deleveraging, Mc Kinsey, February 2015.

economy. China suffers from an economic model that is still too dependent upon exports and investments (the value of gross fixed capital formation/GDP was at 46% in 2013). The trend started by the Chinese authorities to re-balance the economy is ongoing: the contribution of consumption to GDP growth has risen above that of investment (50.2% in 2014), but household consumption is still low and only accounted for 38% of GDP in the same year. As a comparison this share totals between 60% and 70% in most of the OECD economies. More generally, China runs the risk of being caught in the "middle income trap", by which the wage inequalities that are typical of an export orientated economy, limits the emergence of a broad, prosperous middle class, which is essential to stimulate domestic demand; thereby requiring a structural change of the economic model [4].

It is yet too early to gauge precisely the country's ability to rise to the challenge of this slowdown (the "new normality" announced in May 2014 by Chinese President Xi Jinping), as well as the long-term effects of the more expansionist policy chosen by the Chinese government since September 2015 to support the country's economic activity [5]. Nevertheless, several factors do point towards a soft and mid-term landing of the Chinese economy rather than any hard crash scenario. Wage increases, the continued urbanisation process, the progressive redirection of the economy towards services, as well as the strengthening of social protection measures should indeed provide overall support to foster consumption over the next few years (more than 30% of the gross available household income is held in savings to guarantee retirement pensions and healthcare spending). China still has a low stock of capital per head, a large rural labour force [6], as well as true entrepreneurial resources. The massive accumulation of foreign reserves (at 3,430 billion $, the largest in the world) is theoretically enough to absorb the outstanding external debt estimated at 895 billion $ in 2014. We should note however the increasing outflow of capital from China which has intensified over the last few months to total nearly 200 billion $ in September 2015 alone.

Moreover, the decrease in China's GDP growth can also be analysed in a virtuous scenario as a natural development and normalisation process accompanying the upgrade of its economy over the next few years if the reforms necessary to correct the current imbalances are deemed effective. The 3rd Plenum of the Chinese Communist Party which took place in November 2013 led to the announcement of a series of measures to consolidate new sources of growth: notably the liberalisation of the financial system, the reform of local and fiscal debts as well as the modernisation of state-owned enterprises (SOE). Although some reforms have already been launched, others, such as the modernisation of the SOE, are still on-going. But some believe that the window of opportunity to successfully roll this out is rapidly closing: the working age population is swiftly declining which increases the burden of retirement pensions and healthcare spending on the country's finances, whilst at the same time, the economy needs to continue to grow to absorb the massive annual inflow of university graduates to labour force (more than 7 million in 2014). [7] The challenge is therefore significant and the stakes high for the Chinese government to manage this difficult and necessary economic transition successfully.

2. UNCERTAINTIES AND OPPORTUNITIES FOR EUROPE

As China's weight in the EU's external trade has constantly risen over the last few years, the question of the risks incurred by the Eurozone and the European Union is therefore very relevant. China has become the EU's second trade partner in really a very short period of time. In 2006 the country represented 10.1% of the EU's exports and imports in goods, but 13.8% in 2014 (in the same year the USA accounted for 15.2% of the European Union's trade). Europe is also one of the primary sources of FDI going into China, along with Taiwan, Hong Kong, the United States and Japan.

There are at least two main concerns: the trade impact and the financial implications of a long-term slowdown.

*4. See the author's publication, **Chinese and Indian views of Europe since the crisis**, Robert Schuman Foundation, January 2012.*

5. Particularly investments in infrastructures. See Economic Bulletin China n°78, October 2015.

6. China's economic and financial situation, French Treasury General Directorate, May 2015.

7. European Chamber of Commerce in China, Position Paper 2015/2016, p. 9, 8 September 2015.

- From a trade standpoint, the Chinese slowdown will primarily affect the Asian market, which is more directly exposed, as well as raw materials producing countries, of which China is a leading client. China has indeed contributed to up to 72% of Asia's growth since 2000 [8]. The direct impact on European companies should, it seems, be more moderate. Some analysts consider that a 2% loss in the growth of China's internal demand over the next two years, should translate into a 0.6% reduction in GDP growth in the Eurozone [9]. But the trade losses for Europe are likely to be more significant given the impact on the emerging Asian countries as well as on other EU suppliers: if European exports to China now amount to 1.5% of the Eurozone's GDP, Asia as a whole accounts for more than 4%.

The situation, nevertheless, varies within the EU itself. Germany is the most exposed of all the member states: the country totals more than 30% of all Sino-European trade whilst German exports fell by 5.2% in August 2015, its sharpest decline since the financial crisis. Moreover, the share of German exports to China accounts for 2.5% of Germany's GDP (a comparable level to that of Japan), as opposed to 0.6% for the rest of the Eurozone. Although the German economy will, therefore, inevitably be affected, particularly in the construction sector and machineries, the country still has clear room for manoeuver. The impact could well be counterbalanced notably by greater domestic consumption, which has become the main driver of economic growth beyond that of exports since 2012 (domestic consumption contributed to 1.4% of Germany's GDP growth in 2014, net exports to 0.4%) [10].

Trade with China is also relatively small for the other Member States when they are considered individually: the bulk of European trade remains within the single market and Germany alone accounts for 28% of all European goods exports outside of the EU. A decrease of 14.6% in Chinese imports for the whole year would, for example, translate into a more moderate impact for both France and the United Kingdom (a loss equivalent to 0.1% of GDP in both countries, but 0.4% in Germany) [11]. The structural reforms of the Chinese economy, if they are effective, should also open up further opportunities for Europe in the longer term, notably in healthcare but also in the consumer goods sector, particularly luxury goods (an advantage for France and Italy). The Chinese middle class will reach 630 million people by 2022 with the upper part amounting to 54% of urban households, up from 14% in 2012. The contraction in trade could, therefore, be partly compensated by new drivers of growth favouring European imports in the Chinese market if the protectionist trends, which continue to limit market access, do not intensify in the context of a sustained economic slowdown. But EU countries such as Finland, and even Bulgaria, might be amongst the least resilient to the new Chinese situation: their exports to China account for more than 1.5% of their respective GDPs with barely any exports of consumer goods [12].

- Will the financial impact be less acute? The bursting of the Shanghai stock exchange bubble at the end of August, following a more than 150% rise over the year to June 2015, has highlighted the ever-growing linkages between the European and the Chinese markets. The share value of European companies investing in China or those more exposed in terms of trade to the Chinese market were clearly amongst the most affected [13] as share volatility in China now increasingly influences volatility in Asia, the United States and also Europe. This trend is further expected to intensify if the restructuring of the Chinese economy continues with a greater opening of its financial markets. It should, however, be noted that nearly 80% of investors in the Chinese mainland stock markets are small investors (more than 40 million of new accounts were opened between June 2014 and June 2015). The heavy losses on the European markets at the end of the summer were therefore mainly driven by wider doubts and concerns about the general economic slowdown of the Chinese economy.

China has further continued to diversify its investments in American and European sovereign debts over the last few years given the accumulation of its massive foreign reserves, the majority of

8. ***L'Asie à l'épreuve du ralentissement chinois****, Coface, September 2015*

9. OECD forecasts, ***Puzzles and Uncertainties****, 16 September 2015*

10. European Commission working document, SWD(2015) 25 final/2, 18 March 2015

11. Against 1.7% of GDP in Australia, more than 3% in Angola and 0.5% in Brazil. How China's economic slowdown could weigh on the rest of the world, The Guardian, 26 August 2015.

12. See China's slowdown*, Mikkel Barslund and Cinzia Alcidi, CEPS, 25 September 2015.*

13. For example in the luxury goods sector: Louis Vuitton's organic growth was of 3% in the third quarter of 2015 against an initial 5% forecast.

which is believed to be held in dollars and around 25% in euros. This therefore exposes the United States and the EU to a potential risk on short-term securities should China choose to continue to sell part of these assets to provide a greater support to its own currency or economy. The Chinese foreign exchange reserves have indeed fallen by 10% over the last year and again by 87 billion $ in November, the ninth month of decrease in 2015 according to official statistics. However, this downturn should at the same time encourage the European Central Bank to maintain low interest rates for a longer period of time in a context of limited growth in the common market, which should in turn also have positive effects, notably on State borrowings.

For the current slowdown in Chinese growth can also be a source of potential opportunities for European economies:

- The impact of the economic situation in China seems at first rather more favourable for Europe, given its effect on lower energy, agricultural or mineral raw materials prices. The latter has continued to fall in August by 2.8% and in October by 3.9% following reduced activity in China, which notably affected the price of non-ferrous metals (a loss of 4.2%). China currently absorbs some 45% of industrial metal production worldwide, 60% of cement and 17% of wheat productions and is still the leading importer of soya. Though this downward trend had already started with the fall in oil prices and, more generally, a slowing of global growth, it has nonetheless continued to fall substantially over the last months with the collapse of the Shanghai stock market. This translates into a genuine increase in buying power for countries importing raw materials, particularly European member states: a significant support for consumption, but one which could become an impediment to growth if it is not followed by reinforced investments and consumption within and from the EU itself.

- Chinese investments abroad are expected to continue to grow due to declining returns in the country. The flow of Chinese capital into the EU has indeed been growing since 2010 with Chinese FDIs into Europe totalling around 9 billion € in 2013 (including re-investments from Hong-Kong), of which more than 50% of cumulative investments in the United Kingdom, Germany and France between 2000 and 2014 [14] (primarily focusing on the energy, agricultural, food, transport, capital goods sectors and real estate). Moreover, current levels of saving in China are expected to continue whilst seeking low risks investment targets, notably externally. This is partly due to the pattern of an ageing population coupled with the need to finance education as well as the slowing of domestic investments in real estate. All of these elements tend to overall contribute to reinforcing Europe's attractiveness with a possible positive effect for the single market.

Such developments have, however, raised some concerns amongst sections of European public opinion especially when the Chinese investor is a state-owned enterprise (which accounts for a significant part of investments) and against which private companies could find it more difficult to compete at a time of financial austerity. The conclusions of a recent report from the European Chamber of Commerce in China also highlighted remaining constraints to market access and EU sourced FDI in a number of sectors [15]. Yet, a competitive level playing field is an important step towards achieving mutual interests between China and Europe: Chinese investment in Europe and also conversely European interests in China, and thus realise the full potential of the bilateral cooperation in the context of lower growth as well as foster the conclusion of a bilateral investment treaty between the EU and China, the negotiations of which started at the beginning of 2014. This vital issue nevertheless requires a better coordination amongst Europeans to fully grasp the investment opportunities and contain the risks.

***

We should expect the issue of China's soft landing to continue to weigh for some time on global growth. China has indeed entered a second phase of economic transition. The key issue is: can China sustain stable

*14. See **Chinese FDI in Europe and Germany**, Thilo Hanemann and Mikko Huotari, Mercator Institute for China Studies and Rhodium Group, June 2015.*

15. Position Paper 2015/2016, op. cit.

growth sufficient to allow the increasing income levels necessary for the development of a continent size consumer society? China's ability to solve the structural aspects of managing a smooth re-adjustment of its economy will therefore be decisive for its future and also for the interests of its European commercial partners. This more difficult environment should remind us how urgent it is for Europe to re-double the structural reforms necessary to make the single market more complete and competitive, to maximise European employment and higher growth internally. We must hope that the member states of the European Union can rise to the challenge of China's transformation by making full use of the current period of low interest rates and the lower raw materials prices due to the Chinese slowdown, to transform it from a risk into an opportunity and secure the more solid cohesion and strategic control that alone will maximise their wealth creating potential and strengths.

Karine Lisbonne de Vergeron,
Head of Europe Programme and Senior Fellow of the Global Policy Institute.
She has published several books on European issues including the most recent *one China-EU relations and the future of European soft power: A Strategy for a European cultural diplomacy* (LSE Ideas, 2015) and *Chinese and Indian views of Europe since the crisis* (Robert Schuman Foundation and Konrad Adenauer Stiftung, 2012). She is a graduate from HEC and from the London School of Economics in political science.

You can read all of our publications on our site :
www.robert-schuman.eu

Publishing Director : Pascale JOANNIN

THE FONDATION ROBERT SCHUMAN, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France , Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organisation of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.