Chinese Whispers

Economist Insights

The Fed is worrying again about the ongoing deceleration of China's economy and the possible ramifications of a hard landing for the global economy. The trade channel is the most obvious one through which a Chinese hard landing would be transmitted to the rest of the world. But since the direct trade exposure of developed markets to China is relatively limited, why are the markets and the Fed so worried?

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As anyone who has looked at asset prices quickly realises, markets have been feeling worried. They have been worrying about global growth, and in particular about growth in China. The Federal Reserve recently joined in with these concerns, wondering how any global or Chinese slowdown might affect the domestic US economy.

The challenge is that nobody really knows what impact a Chinese slowdown might have on other countries. China was nowhere near as important the last time it went through a separate slowdown. The ongoing deceleration in China puts the Chinese authorities in a difficult position: they must strike a balance between managing down the vulnerabilities in the economy (such as high leverage) and avoiding a disruptive adjustment. If they get the balance wrong there could be a significant shock to the global economy.

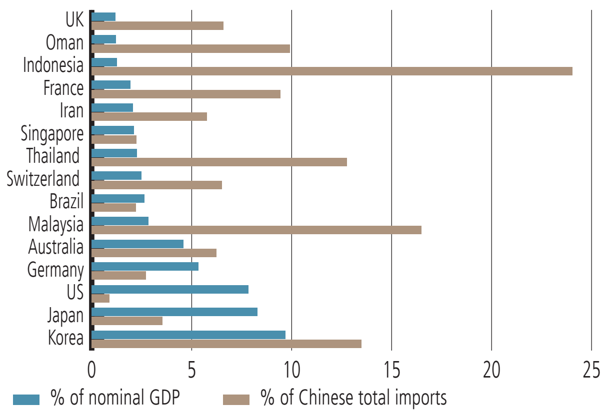
The impact of the hard landing on individual countries or regions is likely to be very different. Figuring it all out is a challenging task for economists, so it is no wonder that the Fed has turned more cautious.

There are also numerous channels through which the impacts of a Chinese hard landing can be transmitted. The most obvious channel is trade. China tends to export more to developed markets than it imports, but it does still import and if China slows down these imports would likely decline. While Chinese imports from developed markets like the US, Germany and Japan may be significant for China, they are less important for those countries.

For instance, imports from the US to China amount to 8% of Chinese imports, but this equates to less than 1% of US GDP (chart 1). So even if there is a significant impact on imports from China slowing down, it is unlikely to have a large direct effect on the US economy. On this basis, even Japan is not that heavily exposed to the direct Chinese trade shock. Many emerging markets, especially in Asia, have a much stronger dependency on China.

Chart 1: Not that import-ant

Exports to China as % of Chinese total imports and national nominal GDP (2014)



Source: IMF, UBS Asset Management

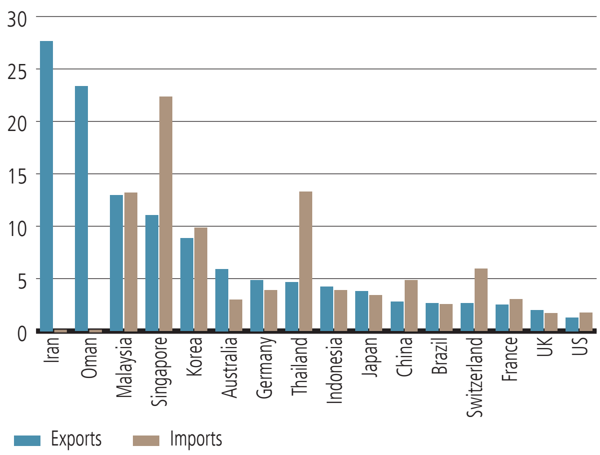
So why should the Fed be worried? Because the direct trade channel is not the only channel. We have had an indication that the financial channel could be quite significant, given how much markets have already moved just on the fear of a Chinese hard landing. But there are also the more indirect trade channels. Several decades of globalisation have left global supply chains a lot more complicated than in the past.

Thirty years ago goods produced in a country were either consumed domestically or exported for final use in another country. Technology and lower shipping costs have made it convenient to shift some parts of the production process overseas where costs are lower. Many goods are imported into a country, processed and then re-exported without ever reaching domestic consumption. Supply chains can pass through many countries.

This global supply chain can spread the effect of a Chinese hard landing further around the global economy. For example, if a country exports goods to China they may produce those goods using imports from other countries. These 'spill-in' effects mean the other countries take a hit as well. Some exports to China may also have been produced using goods that were imported from China, so that lower Chinese imports could have a 'spill-back' effect which reduces Chinese exports as well.

Chart 2: Spilling all over the place

Estimated cumulative drop in exports and imports over 2016-2020 after a 2.5% drop in Chinese imports (%, of 2014 GDP)



Source: A. Kireyev and A. Leonidov "China imports slowdown: spillovers, spillins and spillback", IMF working paper wp/16/51

The combined direct trade spill-overs and indirect spill-ins and spill-backs act as a force multiplier, exacerbating the impact of a Chinese slowdown. Not to mention that countries elsewhere which take a hit to growth also produce their own trade impacts (though in ever decreasing amounts). A recent IMF paper tried to tackle all these complicated issues, using a scenario where Chinese growth slowed by 2.5% more than expected in the IMF forecasts for 2016 and 2017.

This more detailed approach paints a very different picture from the direct spillovers shown above. The total hit to exports for some countries is no longer mild, reaching 5% for countries like Australia and Germany (chart 2). And the impact on Asian economies and certain oil producers are even more substantial. Interestingly, China would also take a hit because the larger global slowdown would mean a drop in their exports as well.

But even this more detailed analysis does not include the other impacts, especially through financial markets, commodity prices and business confidence. All of these could end up being important amplification channels. So in a reversal of the children's game, what starts as a whisper in China could end up as a shout in the US.