October 2015

Global Economy Watch

How big a risk does the slowing Chinese economy pose?

Dear readers,

This month, policymakers from around the world will gather in Peru for the Annual Meetings of the World Bank and the International Monetary Fund. At such a gathering, recent events in China are sure to be under the microscope. But how big a risk do these events pose?

In China, things are looking quite serious as the economy is slowing down and the authorities are attempting to manage the rapid cooling of its property bubble. Dealing with this type of situation is a delicate, difficult and time consuming challenge but Chinese policymakers do have some space for manoeuvre.

South East Asian economies are vulnerable due to their trade links with China. Also, commodity producing economies are facing pressure as demand from China continues to fall. But 'lower for longer' commodity prices should benefit consumers in net commodity importing economies such as the UK and the Eurozone.

Alongside slowing growth in China and low commodity prices, the prospect of a US rate rise is another potential concern for many emerging economies. While the Fed held off putting rates up last month, we still expect the first rate rise to occur later this year.

As a result of these risks in emerging economies, we see a divergence beginning to emerge around the availability of liquidity in different markets. A tightening of liquidity conditions currently seems more likely in the emerging economies than in major advanced economies like the US and the Eurozone. This is worth keeping an eye out for as a sharp slowdown in the availability of credit can amplify the effects of an external shock as businesses and consumers begin to rein in their spending.

Kind regards

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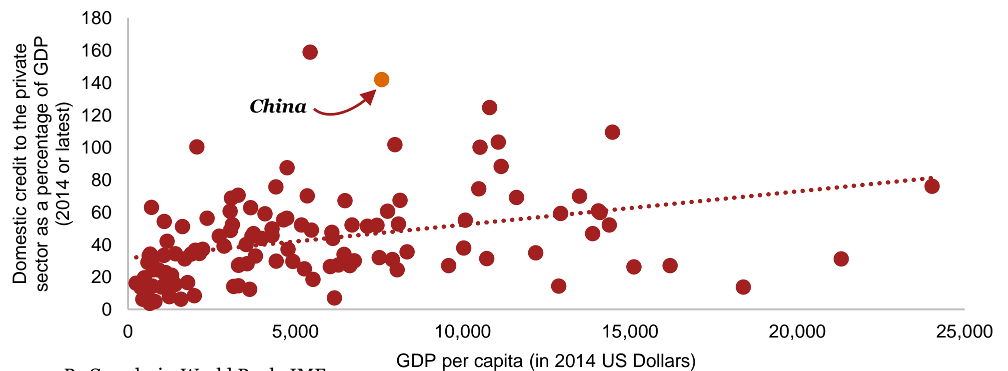
PwC | Senior Economist

Fig 1: Domestic credit to the private sector in China is around 90 percentage points higher than we would expect given income levels



Sources: PwC analysis, World Bank, IMF

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Economic update: emerging markets at risk!

Emerging economies exposed to three risk factors

The world's advanced economies are currently growing at modest though steady rates, but global events are putting pressure on many emerging economies. The US dollar remains strong, which poses a risk to economies with a large amount of dollar denominated debt. Last month, the Federal Reserve opted not to begin raising the US policy rate due to concerns about the wider global economy. However, we still think that the Fed will raise rates in late 2015, which should support the strong dollar and keep the pressure on heavily indebted economies. Alongside this, China's slowing economy and low commodity prices are also putting many emerging economies at risk.

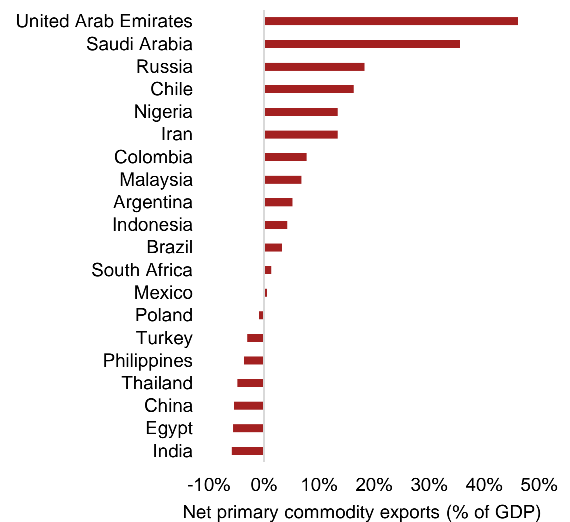
Which economies are the most vulnerable?

On the strong dollar, our May 2015 Global Economy Watch showed that Turkey, Peru, Colombia and South Africa are particularly vulnerable, while the slowdown in China is a particular concern for some of the South East Asian economies (see page 3).

Turning to commodity prices, the IMF forecasts that food, agricultural raw materials, metals and energy prices will all be 'lower for longer'. Focussing on the 20 largest emerging economies, Figure 2 shows that oil exporters such as the UAE, Saudi Arabia and Russia are the most vulnerable to this. However, other net commodity exporters like Chile, Malaysia and Indonesia are also at risk due to lower prices across the board.

The main point to note is that these three factors mean that risks are not concentrated in one region or a few countries but could be felt globally. While we do not expect another global crisis, or a sharp fall in global GDP growth rates, businesses should be prepared for continued volatility and uncertainty in emerging economies.

Fig 2: Emerging economies are exposed to 'lower for longer' commodity prices



Sources: PwC analysis, UNCTAD, IMF

Is a global liquidity squeeze lurking around the corner?

The Fed are preparing for lift-off and some policymakers and businesses are worried. This is mostly driven by concerns about the future availability of funding, or liquidity, rather than the anticipated increase in the cost of funding. So, should they be worried?

Liquidity 101

The main policy tool which drives liquidity is monetary policy which is transmitted domestically, mainly through financial intermediaries, and internationally, through cross-border capital flows*. From a macroeconomic point of view, the key outcome of liquidity is credit growth.

In a business context, liquidity also acts as a vital, short-term buffer against economic downturns. Typically, the lack of liquidity tends to amplify the impact of negative external shocks.

US and the Eurozone: Awash with liquidity

In the US, a sudden liquidity squeeze seems unlikely even though monetary policy is expected to tighten by a small margin in the near future.

The prospect of a higher policy rate has already led to a trend of on-shoring dollars which has a positive knock on effect on liquidity. We don't expect this trend to reverse, particularly given the ongoing uncertainties in some key emerging economies.

The risk of a liquidity freeze in the Eurozone is also a remote possibility. In fact, during early September, Mario Draghi re-affirmed the ECB's position to expand its asset purchase programme if inflation expectations fail to revert to target. Also, the latest lending survey suggests that banks – which are the main source of funding for most businesses - are expected to lend more in the coming months.

China: Exposed but manageable

Figure 3 shows that credit growth is drying up in China compared to the historic average. This, in addition to the erratic movement of the stock exchange coupled with the unexpected devaluation of the renminbi, suggests that liquidity might be drying up.

However Chinese policymakers have ample room for manoeuvre in case the current liquidity crunch grows into a bigger liquidity crisis. The most important and direct tool at hand is the reserve requirement ratio that stands at 18% for large banks.

Keep an eye on emerging economies

Many emerging economies are facing a period of uncertainty with Fed rate rises, slowing growth in China and 'lower for longer' commodity prices on the horizon (see Economic update). As a result, a tightening of liquidity conditions in these markets seems more likely than in the advanced economies, and businesses need to be aware of these risks.

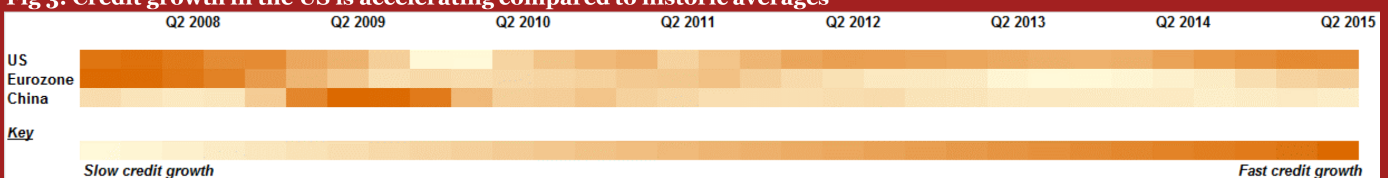
Global liquidity squeeze seems unlikely

Overall, central banks around the world have stated their willingness to provide ample liquidity subject to meeting their primary mandates to maintain price stability.

With commodity prices taking a nosedive, and global aggregate demand growing at a moderate pace, the possibility of a global liquidity squeeze therefore seems unlikely, but risks could arise in some emerging markets

**Regulation can also play an important role in driving liquidity trends. We have analysed this in depth in our Global Financial Markets Liquidity Study available here.*

Fig 3: Credit growth in the US is accelerating compared to historic averages

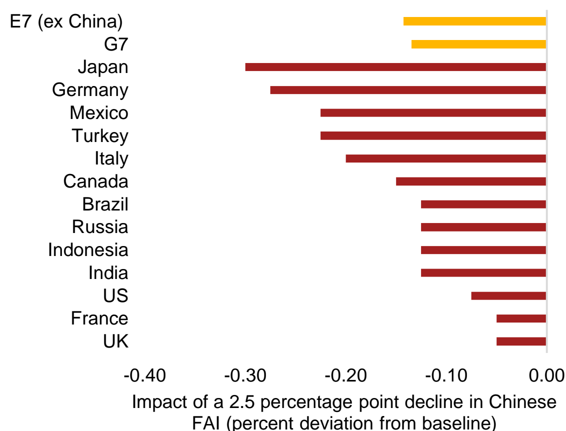


We calculated the pace of credit growth by estimating the extent to which credit provision is growing compared to its 25 year historic average. For China we used the 17 year average.

Sources: PwC analysis, Datastream

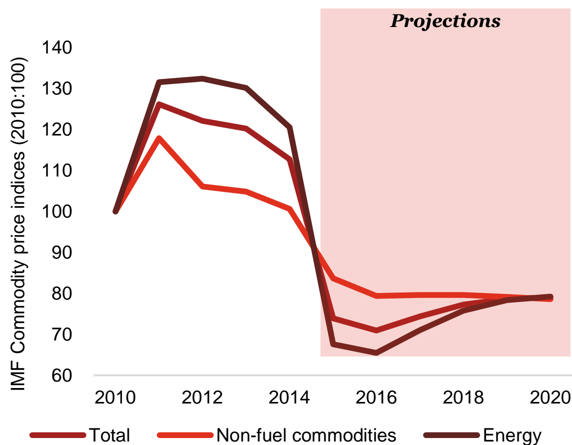
China, unmasked

Fig 4: A slowdown in Chinese investment alone could probably be contained by the world's largest economies



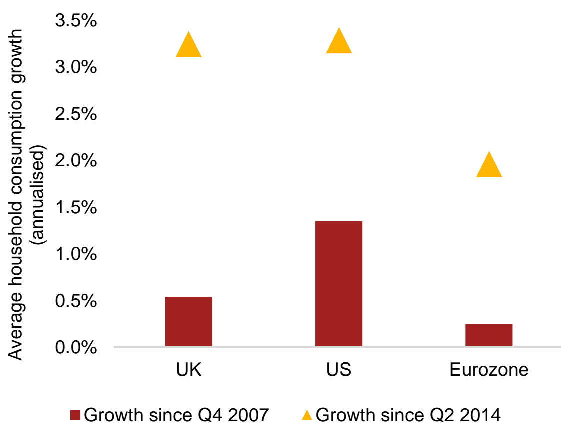
Source: PwC analysis of IMF research

Fig 5: Commodity prices are expected to be 'lower for longer'



Source: IMF

Fig 6: Lower oil prices are one factor which have contributed to households increasing their spending



Sources: PwC analysis, National statistical authorities, Datastream

China: The third stage of the global financial crisis?

China is slowing down as policymakers manage the rapid cooling of its debt-fuelled property bubble. The build-up started around seven years ago, partly as a response to the financial crisis and also as a means to accelerate urbanisation. Since then domestic private sector leverage increased from around 107% of GDP in 2007 to just over 140% last year. In contrast, nominal GDP growth declined from 18% in 2008 to around 8% in 2014 (driven by a stronger yuan against the dollar and domestic wage pressures) making it harder to repay the debt.

Figure 1 shows how indebted the Chinese private sector is compared to other emerging and developing economies. According to our analysis this is around 90 percentage points, or around 9 trillion US dollars (in 2014 prices), higher than we would expect given its average income levels. China also has very high levels of local government debt and there are now concerns that a sharp slowdown in China could trigger another stage of the global financial crisis.

Where has all the money gone?

Most of the money was channelled into fixed asset investment projects ("FAI"), especially real-estate and other hard infrastructure. As a result, by 2014 China's investment to GDP ratio had increased to around 47%, close to double the rest of the E7 average.

Within a relatively short space of time, China became the world's biggest importer of iron ore, steel and prefabricated buildings. Impressively it has also accounted for around one third of the global increase in rail capacity since 2008.

Impact on Chinese economic growth

Past experience has shown that managing debt-fuelled property bubbles is a delicate, difficult and time consuming policy challenge. Therefore, the seriousness of events underway in China should not be underestimated. However, on the plus side, China has around $3.5 trillion of foreign exchange reserves (although there are some questions as to how fast these can be used) and adequate space for policy manoeuvre to help manage the crisis. Based on this, we expect the Chinese economy to grow by just under 7% in 2015, but then to decelerate to around 5-6% average annual growth in the medium-term, with most of the slowdown attributed to lower fixed investment activity and slower export growth. There may well be further cuts in the Chinese policy rate and to banks' reserve requirement ratios to ease this slowdown.

Impact from a Chinese investment slowdown

IMF simulations[1] suggest that, on average, the world's large economies, the G7 and E7 (ex China), would be able to contain the effects of a modest slowdown in Chinese investment (see Figure 4). However the distribution impact of the slowdown would depend on a range of factors including, for example, the strength of trade and financial linkages. Of the G7, Japan, Germany and Italy are projected to be the most exposed. For the E7 (ex China), Mexico and Turkey are projected to be more susceptible to a Chinese investment slowdown. For Turkey, the combination of a high stock of foreign currency private sector debt coupled with an already weak Lira, might amplify the external shock even more. However, the impacts of an investment slowdown are only one part of the story.

South East Asian economies more exposed

Some of the South East Asian economies are expected to be more exposed to slowing economic growth in China. This is not surprising as, over the past 15 years, these economies have repositioned themselves as an integral part of Chinese manufacturers' supply chains. But we think a crisis similar to the scale of the 1997 East Asian crisis is unlikely. Most South East Asian economies have adequate fiscal and external buffers to manage a downturn. More crucially, most have moved to flexible exchange rate regimes which have in turn responded to external pressures. However, for businesses this could imply more short-term volatility of exchange rates which will need to be managed.

Commodity prices: Lower for longer

Another consequence of slower growth in China will be lower commodity prices (see Figure 5) because of slower short-term Chinese demand growth, an upswing in supply in key asset classes like oil given developments in Iran, the reluctance of Saudi Arabia to cut output and earlier expansions in US shale oil capacity that will take time to run down.

There will be winners and losers depending on commodity importer and exporter status. Major exporters like Russia, Nigeria and Brazil are expected to face some pressure. But in the absence of any other severe adverse shocks, a 'lower for longer' commodity price scenario is projected to be good news for consumers in net commodity importing economies like the UK and the Eurozone. This is likely to be one factor (although certainly not the only one) which has contributed to the relatively stronger consumer spending growth seen since the middle of last year (see Figure 6).

Overall, events in China present a downside risk to the emerging economies in particular, but the negative effects should be less severe for most advanced economies.

[1] Investment-Led Growth in China: Global Spillovers, IMF Working Paper, 2012

Projections: October 2015

	Share of 2014 world GDP		Real GDP growth				Inflation			
	PPP	MER	2014	2015p	2016p	2017-2021p	2014	2015p	2016p	2017-2021p
Global (Market Exchange Rates)		100%	2.8	2.8	3.1	3.1	2.3	1.8	2.5	2.5
Global (PPP rates)	100%		3.4	3.3	3.6	3.6				
United States	16.1%	22.5%	2.4	2.6	2.8	2.5	1.6	0.2	1.8	1.9
China	16.3%	13.4%	7.4	6.9	6.5	5.7	2.1	1.8	1.8	3.0
Japan	4.4%	6.0%	-0.1	0.9	1.7	1.3	2.7	0.9	1.0	1.9
United Kingdom	2.4%	3.8%	2.9	2.5	2.4	2.3	1.5	0.2	1.6	2.0
Eurozone	12.2%	17.4%	0.8	1.5	1.6	1.7	0.5	0.2	1.1	1.4
France	2.4%	3.7%	0.2	1.1	1.3	1.9	0.6	0.2	1.1	1.2
Germany	3.4%	5.0%	1.6	1.5	1.7	1.6	0.8	0.4	1.6	1.7
Greece	0.3%	0.3%	0.7	-1.1	-2.5	2.5	-1.4	-1.2	-0.2	1.4
Ireland	0.2%	0.3%	5.2	5.7	4.6	2.5	0.3	0.2	1.0	1.5
Italy	2.0%	2.8%	-0.4	0.7	1.2	1.3	0.2	0.1	0.9	1.4
Netherlands	0.7%	1.1%	1.0	2.0	1.5	1.9	1.0	0.8	1.3	1.3
Portugal	0.3%	0.3%	0.9	1.7	1.8	1.8	-0.2	0.6	1.1	1.5
Spain	1.5%	1.8%	0.7	3.1	2.6	2.0	-0.2	-0.5	0.6	1.2
Poland	0.9%	0.7%	3.5	3.7	3.4	3.2	0.2	-0.8	1.1	2.5
Russia	3.3%	2.4%	0.6	-5.0	-0.5	1.9	7.8	15.0	8.0	4.3
Turkey	1.4%	1.0%	2.9	2.7	3.0	3.7	8.9	7.9	6.9	6.2
Australia	1.0%	1.9%	0.7	2.6	2.2	2.9	2.6	2.5	2.6	2.5
India	6.8%	2.7%	7.0	7.5	7.9	6.1	3.8	-1.5	4.3	6.0
Indonesia	2.5%	1.1%	1.2	4.9	5.0	5.4	6.4	6.8	5.8	5.1
South Korea	1.6%	1.8%	3.3	2.8	3.3	3.5	1.3	0.9	1.9	2.9
Argentina	0.9%	0.7%	0.5	2.1	1.7	2.1	-	20.0	25.0	-
Brazil	3.0%	3.0%	0.1	-1.8	0.4	3.1	6.3	8.5	6.5	4.8
Canada	1.5%	2.3%	2.4	1.0	2.0	2.2	1.9	1.2	2.0	2.1
Mexico	2.0%	1.7%	2.1	2.3	3.0	3.9	4.0	2.9	3.2	3.1
South Africa	0.7%	0.5%	1.5	1.0	1.8	3.2	6.1	4.8	5.6	5.3
Nigeria	1.0%	0.7%	6.2	3.5	4.5	6.0	8.0	9.3	10.0	7.3
Saudi Arabia	1.5%	1.0%	3.5	2.6	2.3	4.4	2.7	2.1	2.5	3.4

***Sources:** PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index. We will provide a 2017-2021 inflation projection once a longer time series of data is available. There is not a complete series of year-on-year price growth data available for 2014 so we have not provided an estimate for annual inflation in this year. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise later in 2015	27-28 October
European Central Bank	0.05% (September 2014)	Rate on hold until at least late 2016	22 October
Bank of England	0.5% (March 2009)	First rise expected in early 2016	8 October

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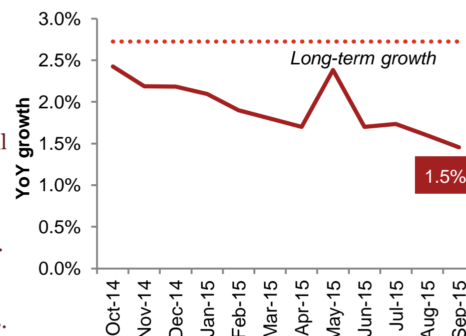
PwC's Global Consumer Index

Growth in consumer spending fell in September, once again below its long-term growth rate. Equity market's performance deteriorated following uncertainty over global macroeconomic conditions and slowing growth in China. Greater uncertainty also led to a decline in global consumer and business confidence, particularly in emerging markets. Although industrial production improved slightly, ongoing uncertainty could be a drag on consumer spending in the coming months.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit ***www.pwc.co.uk/globalconsumerindex***

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