THE AUSTRALIAN

The China syndrome: China poses a risk to the world economy

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China's leaders may not have a clue as to where they are going, but they seem determined to get there as soon as possible. The question is how much damage will be done to the world economy along the way. With world stockmarkets alternating between precipitous falls and short-lived rallies, commodity prices tumbling and economic growth forecasts slashed, the answer seems to be plenty.

But the dramas that have been playing themselves out over the past two weeks are certainly not due to China alone. If Beijing's mishaps have resonated so loudly, it is because there are few other sources of momentum in the world economy that could offset China's weakening.

And to make matters worse, global fragilities and possible points of failure have multiplied in recent years as longstanding structural problems have been left unresolved. While China's leaders have not covered themselves in glory, they are not alone in struggling to take the tough decisions needed to restore durable growth.

That a slowing China would be bad news, particularly for resource exporters such as Australia, is hardly surprising. China may only generate a sixth of the world's gross domestic product (the broadest measure of the volume of goods and services produced) but it has accounted for around a third of global growth over the past decade. And with China's phase of rapid expansion being nearly twice as resource intensive as Japan's was, its infrastructure splurge — which saw China consume more cement in the years 2011 to 2014 alone than the US used in the entire 20th century — pushed both commodity prices and outputs to historic highs.

It was therefore entirely predictable that a tapering in China's growth rate would sour the world economic outlook, hitting commodity exporters especially hard.

But the fallout has been far greater than most observers expected. For example, on conventional estimates, each 1 percentage point decline in China's growth rate should cut growth rates in other Asian economies by no more than 0.3 to 0.4 percentage points; now, the World Bank believes the reduction could be closer to 0.8 percentage points.

And with economists at UBS estimating that if China's growth slumped to 4 per cent this year (as compared with the International Monetary Fund's forecast of 6.3

per cent), the effect would be to slice half a percentage point off US growth, 0.8 percentage points off Europe's and 2.6 percentage points off Japan's, it is easy to understand why markets are skittish.

Yet the global reaction has been as fierce as it has because growth rates are already so anaemic.

It is true that the US is in the sixth year of a recovery that has seen unemployment fall from 10 per cent in 2009 to 5 per cent last month. Nonetheless, even optimists expect GDP growth this year to be in the order of 2.3 to 2.6 per cent, well below the 3.3 per cent the US economy averaged between 1950 and 2014; and there have been numerous signs of a slowdown in recent months, leading some economists to suggest that the annualised growth rate may have dropped, in the fourth quarter of 2015, to barely 2 per cent. However, even that 2 per cent looks good compared with the eurozone, which grew by just 1.6 per cent last year, not enough to materially reduce its 22.5 per cent youth unemployment rate. Nor is the situation in the eurozone likely to improve anytime soon, with economists at Citi Research forecasting that the growth rate of GDP will be only 0.1 percentage point higher this year than it was last year. As for Japan, all the rhetoric about "Abenomics", no matter how fervently it has been repeated, did not prevent it slipping into recession last November for the fifth time in seven years.

Unfortunately, the prospects for the emerging economies, which kept global growth going through the financial crisis, seem bleaker yet. In October 2012, the IMF expected those economies to grow by over 6 per cent in 2015; it now seems likely that their actual growth rate last year was closer to 4 per cent, most of which came from China. And however serious China's difficulties are, they pale compared to those of Russia and Brazil, which are in the throes of deep recessions, while South Africa, whose economy shrank in the second half of 2015, is struggling with steep declines in both mining and agriculture.

The threat of a renewed debt crisis compounds the problems. During their boom years, debt levels in the emerging economies burgeoned, rising to nearly 200 per cent of those economies' combined GDP. Virtually all of that increase was due to borrowing by non-financial corporates, which found willing lenders in the advanced economies where central banks had driven interest rates to record lows and used "quantitative easing" to expand the availability of credit. As a result, the foreign currency denominated debt held by non-financial corporates in the emerging economies grew from $US1.8 trillion in 2010 to $US3 trillion in 2014, while total corporate debt in those economies rose from just $US4 trillion in 2004 to $US18 trillion a decade later.

Now, however, the ability to service that debt and roll it over as repayments come due seems increasingly doubtful. Slowing growth rates have reduced the revenues from which borrowers can fund repayments just as sharp falls in emerging economies' exchange rates mean the cost of servicing debts has risen in domestic currency terms; at the same time, higher US interest rates and the possibility of further rate rises this year have redirected liquidity away from emerging economies, with the Institute of International Finance estimating investors withdrew around $US1 trillion over the course of 2015.

Were those pressures to lead to a wave of defaults, the consequences could be severe and far-reaching: in its simulations of a worst-case scenario, the IMF finds that broad turmoil would slash around 2.5 percentage points off economic growth in the richer countries through 2017, causing a fall in GDP. But even if it doesn't come to that, the debt will weigh on the emerging economies' growth prospects for years to come.

Finally, falling oil prices — which the IMF hailed as a stimulus to growth only last year — are proving to be anything but a panacea, adding to the downside risks.

From 2011 to 2014, Brent oil almost always cost more than $US100 a barrel; last week, the price dipped to just $US30 ($43) a barrel, its lowest level since 2004. For sure, the 70 per cent fall in prices makes global consumers better off by close to $US7.8 billion a day; but, so far at least, the effect on demand has been relatively modest, with US consumers, for example, saving nearly half the windfall.

Producers, in contrast, are feeling the pain in full, not only in the traditional oil exporting countries but also in the US, where the shale energy boom increased oil production by 50 per cent and boosted oilfield capital expenditures to 2.3 per cent of GDP. As a significant share of those expenditures was financed through sub-investment grade bonds, collapsing prices have caused more than mere ripples in financial markets, accentuating the broader sense of concern.

Moreover, as oilfields investment has shrunk, American manufacturing, which was already suffering from the appreciation of the US dollar, has taken a sizeable hit, recording two consecutive months of contraction at the end of last year for the first time since 2009.

The decline in oil prices also has broader geopolitical effects, which will only become more pronounced with Iran's likely return to world oil markets later this year. As well as worsening the overproduction, the intensifying rivalry between Saudi Arabia and the Gulf states on the one hand, and Iran and its allies in Russia and Iraq on the other, cannot but spill over into the armed conflicts engulfing the greater Middle East, heightening uncertainty and sapping consumer and business confidence alike.

Altogether, world markets face a year where mediocre outcomes would be a welcome relief.

Yet the policy response is far from encouraging.

At the macroeconomic level, the reason is clear: monetary policy, which has borne so much of the brunt since the global financial crisis, is reaching the limits of its effectiveness.

In the eurozone, for example, interest rates are already in negative territory, with even Italian and Spanish one to two-year government bonds offering investors negative returns. That hasn't stopped the European Central Bank from deciding, at its December meeting, to extend and expand its program of quantitative easing, but it does restrict that program's likely impacts.

Moreover, the fact that central banks are now on such divergent paths — with the US Federal Reserve beginning what it expects to be a series of gradual increases in rates, while the ECB and the Bank of Japan remain committed to keeping rates at record lows — itself creates significant problems for monetary policy.

In effect, when the major countries' interest rates move more or less in unison, as they did for the first decade of the 2000s, investors have less incentive to shift between currencies, thus keeping exchange rate volatility within reasonable bounds.

In contrast, when central banks go it alone, the resulting exchange rate swings can make attempted interest changes unsustainable, as the ECB learned in 2011 and as the Federal Reserve may find in the months ahead. Given that possibility, investors doubt the credibility of the Federal Reserve's stated intentions, blunting the effectiveness of its policy stance.

As monetary policy runs out of steam, governments are instead reverting to the time-tested formula of opening the spending taps, with looming elections making pump-priming all the more attractive.

Thus, in Japan, where the ratio of gross public debt to GDP rose from 67 per cent in 1990 to 246 per cent in 2015, cabinet approved a record 96.72 trillion yen budget for fiscal year 2016 on Christmas Eve, positioning Prime Minister Shinzo Abe's Liberal Democratic Party for the forthcoming elections to the House of Councillors.

Equally, in the US, where federal debt has grown from 35 per cent of GDP in 2007 to 74 per cent today (and is projected to exceed 100 per cent of GDP by 2039), this year's elections must have weighed on legislators' minds as they weakened caps on spending while making a whole series of tax cuts permanent.

China, too, has embarked on that path, with total government spending rising sharply during the latter part of last year, to be up by more than one-quarter over the same time a year before.

And last but not least, the European Union, having granted France (which faces a crucial presidential election next year) a special exemption from meeting its budget targets in the wake of November's terrorist attacks, is under intense pressure to broaden that exemption, in the first instance to the countries affected by the surge in asylum-seekers.

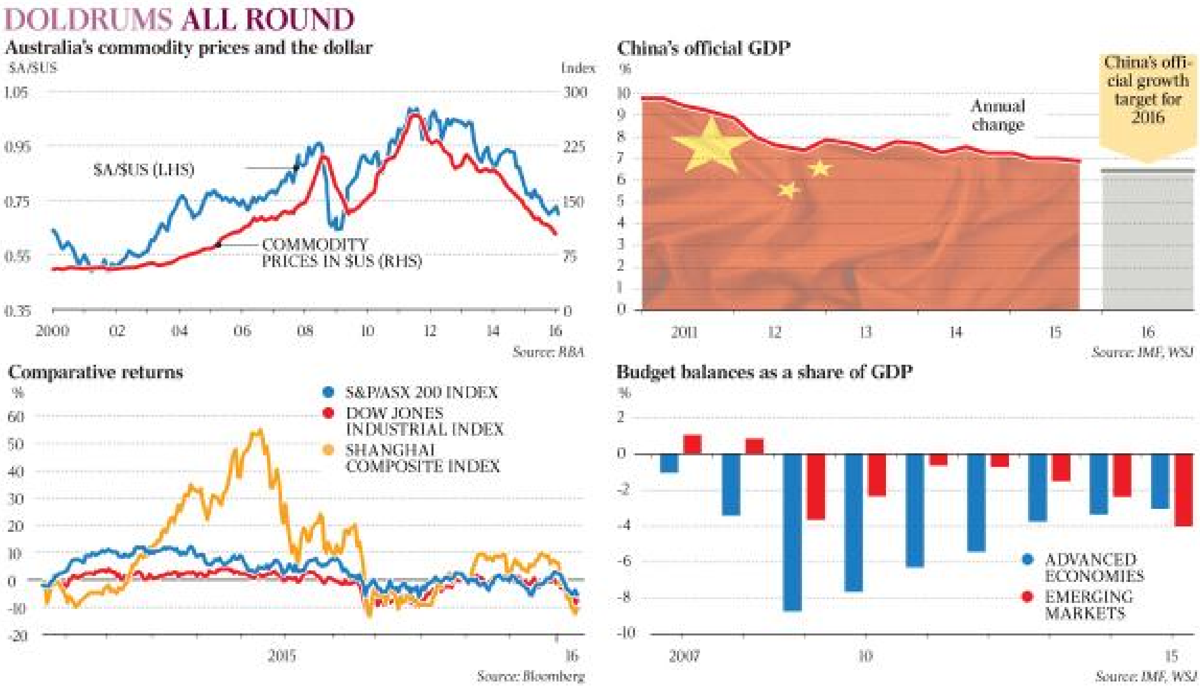
How successfully those increases in spending will cushion any slowing in economic activity remains to be seen.

What is certain, however, is that the structural constraints on a return to sustained expansion are not being addressed. In the emerging economies, for example, multi-factor productivity growth, which measures the increase in the efficiency with which both capital and labour are used, has shrunk from its 2003-08 average of over 2 per cent a year to barely above zero.

Nor are the emerging economies outliers in that respect, with today's multi-factor productivity growth rates in the US and the EU some two-thirds lower than they were a decade ago.

Slower, more volatile growth, which diminishes the scope to compensate the losers from change, will only make it harder to tackle the underlying causes of stagnant productivity. So, too, will the nearly universal erosion of public confidence in government, as the lack of trust means that instead of clear mandates, governments get fleeting opportunities to earn their survival. As the world economy limps on, nowhere has a style of retail politics emerged that combines the clearmindedness of a Margaret Thatcher with the optimism of a Ronald Reagan into a package that both resonates with voters and is capable of confronting the painful choices.

It is therefore far too easy to point the finger at China. Yes, its leaders seem uncertain at best, bumbling and heavy-handed at worst, trapped between market-oriented reforms they know are needed and the authoritarian's fear of losing power. But where is the Western leader who can help by setting an example, as Thatcher and Reagan did, in their own way, for Deng Xiaoping? As the Trumps and Corbyns of this world flourish, China's woes, instead of being the source of our problems, are their grimmest mirror.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$A/$US
Index
$A/$US (LHS)
COMMODITY PRICES IN $US (RHS)
Source: RBA
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Annual change
China's official growth target for 2016
Source: IMF, WSJ
Comparative returns
%
S&P/ASX 200 INDEX
DOW JONES INDUSTRIAL INDEX
SHANGHAI COMPOSITE INDEX
Source: Bloomberg
Budget balances as a share of GDP
%
ADVANCED ECONOMIES
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