News release

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Pages	

China's slowing economy poses major challenge for some economies, say PwC economists

China is slowing down as policymakers manage the rapid cooling of its debt-fuelled property market. Past experience shows that this is a delicate, difficult and time-consuming policy challenge, say PwC economists.

The build-up of the property bubble started around seven years ago, partly as a response to the financial crisis and also as a means to accelerate urbanisation.

Domestic credit to the private sector in China is equivalent to just over 140% of GDP. China also has very high levels of local government debt and there are now concerns that a sharp slowdown could trigger another stage of the global financial crisis.

So where has all the money gone? PwC senior economist Richard Boxshall says: "Most of the money was channelled into fixed asset investment projects, 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.

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.

Says Richard Boxshall: "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."

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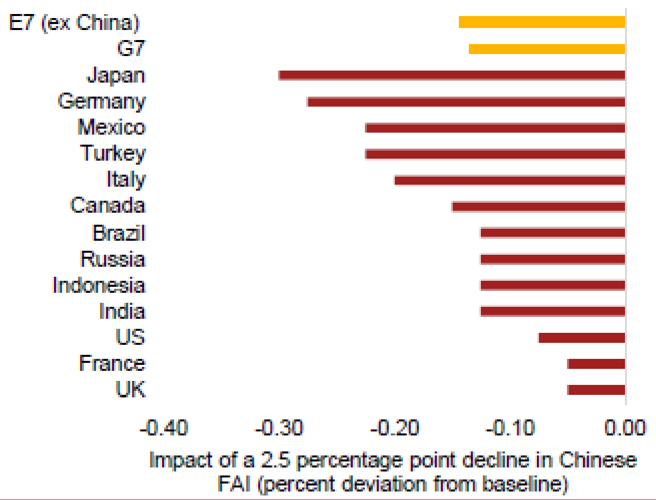
International Monetary Fund simulations suggest that, on average, the world's large economies, the G7 and E7 (excluding China), would be able to contain the effects of a modest slowdown in Chinese fixed asset investment (FAI). Of the G7, Japan, Germany and Italy are projected to be the most exposed. For the E7, Mexico and Turkey are projected to be more susceptible to a Chinese investment slowdown (see Figure 1). However, the impacts of an investment slowdown are only one part of the story.

Fig 1: A slowdown in Chinese investment alone could probably be contained by the world's largest economies



Source: PwC analysis of IMF research

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.

However, 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.

Another consequence of slower growth in China will be lower commodity prices for longer. 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.

The strong dollar is another pain point for emerging markets, particularly as the Federal Reserve is still expected to increase rates later this year.

Concludes Richard Boxshall: "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."

Notes:
The October edition of PwC's *Global Economy Watch* can be found at www.pwc.com/gew .

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