ALTERNATIVE SCENARIO

What if China's economic growth were to slow substantially?

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This review examines two scenarios that allow a brief analysis of how a rapid but controlled restructuring of China's economy and a sudden halt of debt-driven growth would impact the Chinese and euro area economies. These estimates suggest that even a strong deceleration in China's growth would not considerably dampen euro area growth. If confidence were to suffer globally, however, euro area growth would slow considerably more than estimated.

The Chinese economy has grown at a remarkable pace ever since the introduction of market reforms at the beginning of the 1980s. In recent years, however, China's growth has been largely debt-driven. Growth based on strong reliance on debt is typically unsustainable and involves the risk of a sudden halt if the debt bubble bursts. Therefore, from the perspective of stable developments, a gradual transition from an investment-led growth structure towards an economy driven by consumption would be welcome. However, even if China were to be able to restructure its economy in a controlled manner, its growth would still slow from its current pace.

Below, we will briefly examine two alternative scenarios.[1] The first scenario analyses the effects of economic restructuring in China on Chinese and euro area growth. The second

1. The Global Integrated Monetary and Fiscal Model (GIMF), Kumhof, Laxton, Muir & Mursula (2010) IMF WP 10/34.

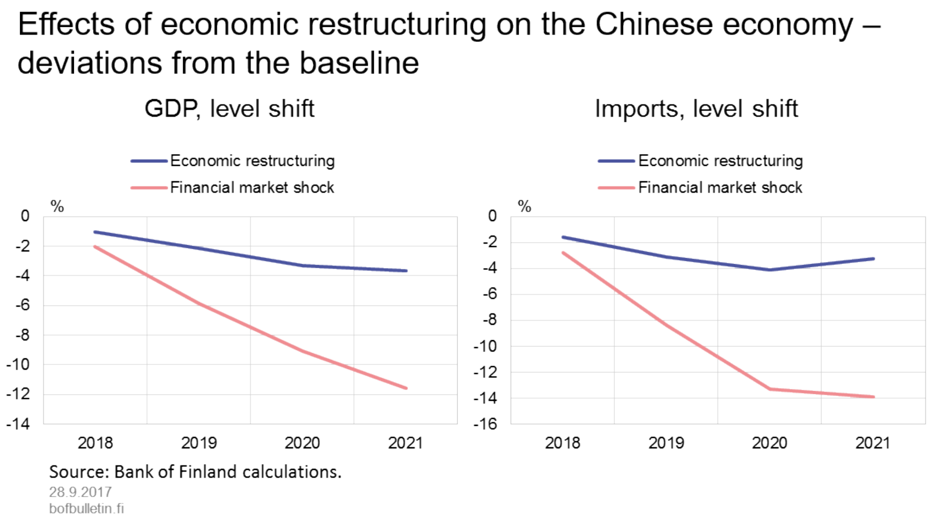
scenario examines a situation in which a financial market shock leads to a sharp deceleration in China's debt-driven growth. The calculations are based on the assumption that the Chinese central bank keeps the exchange rate between the yuan and the US dollar unchanged, but otherwise its monetary policy responds according to an inflation-targeting monetary policy rule.

Scenario 1. Restructuring of China's economy

The first alternative scenario assesses how economic restructuring in China impacts Chinese and euro area growth.

It is assumed that the pace of investment in China moderates, which leads to slower economic growth, even with a simultaneous slight improvement in private consumption growth. As a result, weaker investment drags down potential output due to lower productivity growth. Based on this scenario, China's GDP four years ahead can be estimated to be about 4% lower than in the Bank of Finland forecast (Chart 1).[2] This means that China's economic growth slows by a good 1 percentage point for the next 3 years, after which it picks up gradually. Weaker domestic investment demand leads to a contraction in imports, albeit temporarily.

Chart 1



Scenario 2. An abrupt halt in debt-driven growth

The second scenario assumes that China's heavily debt-driven growth slows sharply and for a prolonged period. The slowdown is triggered by a shock stemming from the financial markets, which leads to a steep rise in companies' financing costs. With an abrupt rise in risk premia on external funding, companies substantially scale down their investment.

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2. In the economic restructuring scenario, global GDP contracts by about ½% over the medium term. In the financial market shock scenario, global GDP contraction is around three times this.

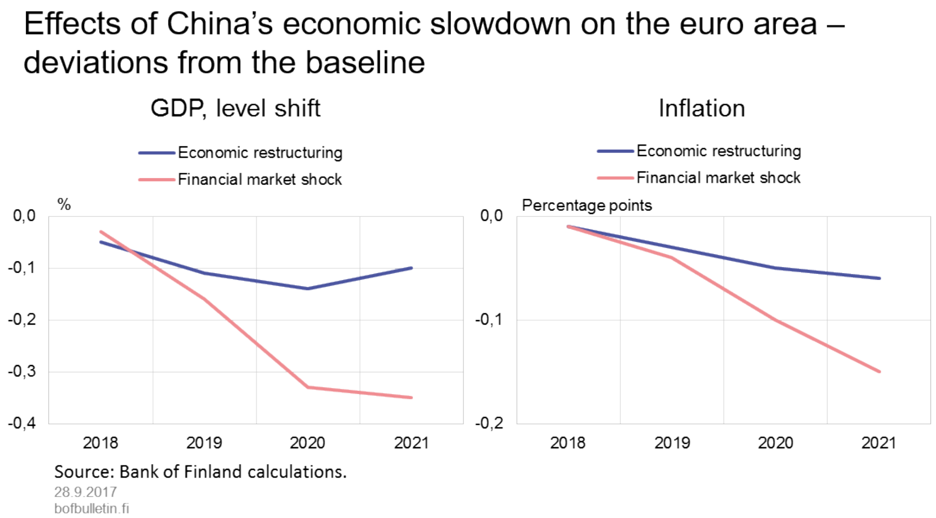
In this scenario, lower investment also reins in potential output. At the same time, a collapse in economic confidence strongly reduces private consumption. This scenario suggests that China's GDP four years ahead is about 12% lower than in the Bank of Finland forecast (Chart 1). This means that the annual growth rate of GDP slows by 2–4 percentage points in 2018–2021. Consequently, China's average growth is cut by half, which corresponds in magnitude to a similar slowdown in the Chinese economy as during the financial crisis. Imports will now contract steeply, and even slightly more strongly than GDP.

The effects on the euro area

A comparison of the effects of the two alternative scenarios on the euro area (Chart 2) shows that under scenario 1 of China's economic restructuring, euro area GDP would remain only slightly lower than forecast. Consumer price inflation slows less than GDP growth.

If the Chinese economy were hit by a financial market shock, the effects would be slightly more pronounced: euro area GDP would be nearly 0.4% lower than forecast and inflation would fall by about 0.1 of a percentage point during the next few years.

Chart 2



There are many reasons why even an abrupt halt in China's debt-driven growth would only have a marginal impact on the euro area.

China's economic slowdown can affect the euro area in several ways. The direct effects come via trade flow channels, changes in net foreign asset items and exchange rate changes. A significant deceleration in Chinese growth would also depress the real interest rate globally. These factors have been taken into account in our estimates.

On the other hand, the transmission of factors relating to confidence and risk premia across countries has not been accounted for in the calculations. For this reason, the estimated spillover effects on the euro area can be regarded more or less as minimum effects. However, it is very likely that a strong deceleration in Chinese growth would weaken confidence globally and raise the price of funding. Hence, euro area growth would also moderate considerably more than in these calculations.

In addition to the spillovers from weaker confidence, euro area growth could decelerate more than estimated if China were to allow its exchange rate to depreciate. If the yuan were to be allowed to depreciate, euro area growth and inflation would slow even more strongly than estimated.

Tags

alternative scenario, China, euro area