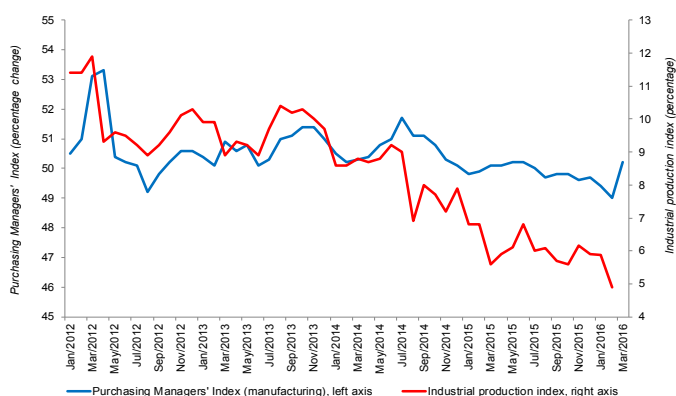


## Spillovers to Asia-Pacific economies from recent economic developments in China

China's increasing status in the global economy has meant that developments in the country are exerting strong impacts on other countries, including those in the Asia-Pacific region. China now accounts for 40% of the total GDP of developing Asia-Pacific economies. It has surpassed the United States to become the largest individual trading partner in the Asian and Pacific region, with the country sourcing more than 40% of its imports from other Asia-Pacific countries. In line with its large economic weight, the past year has also seen China assume a larger role in global and regional economic policymaking and cooperation. This year sees China holding the presidency of the G20 group of countries, with the country proposing a wide-ranging programme of initiatives to bolster international cooperation. In late 2015, the board of the IMF approved the inclusion of the Chinese renminbi in the basket of currencies on which the special drawing rights of the IMF are based. The inclusion of the Chinese currency in the basket is an acknowledgment that the renminbi can potentially become a truly international currency. Within the region, China has moved forward on a number of major development cooperation initiatives. For instance, the Asian Infrastructure Investment Bank, led by China, with authorized capital of \$100 billion and initial subscribed capital of about \$50 billion, will play an important role in providing financing for infrastructure development. Similarly, the "Silk Road Fund" would also support megaprojects of the "one belt one road" initiative, with investment in various infrastructure projects as its centrepiece.

Two significant events in China in the past year have had large spillovers for the region's economies — the gradual economic growth moderation and movements in its currency. Economic growth in China is forecast to be around 6.5% for 2016 and 6.3% for 2017, continuing the growth moderation from an estimated increase to 6.9% in 2015. Moderating growth in China is being driven partly by a much-needed rebalancing to sustain growth in the medium term, away from investment and net exports and towards consumption, as well as away from manufacturing and towards services (figure 1).

Figure 1. China's industrial production index and Purchasing Managers Index



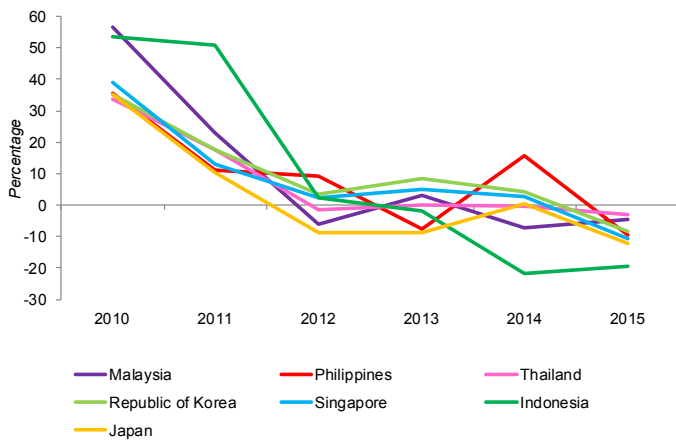
Sources: ESCAP, based on CEIC Data. Available from [ceicdata.com](http://ceicdata.com) (accessed 25 April 2016).

The impact of the growth moderation in China on the region has come largely through weaker trade prospects and declining commodity prices. Key among sectors of domestic investment in China that are expected to assume a lesser role in coming years are real estate investment and infrastructure spending in the more developed parts of the country. The need for raw material commodities in these sectors had been the key driver of China's emergence as the largest commodity importer in the world. Thus, moderating growth in China together with overall weak global economic growth have had a particularly strong negative impact on growth performance of commodity-dependent economies in the region, such as the North and Central Asian economies and Indonesia, Malaysia and Mongolia. In some of these economies, subdued commodity prices have significantly weakened their terms of trade and external account performance, which have resulted in deep currency depreciations and higher inflation rates.

Manufacturing exporters in the region are also experiencing significant impacts due to the growth moderation in China (figure 2). This is due both to the drop in China's final exports, implying less

demand for Asia-Pacific intermediates, as well as the slowdown in Chinese demand for final products. Among manufacturing economies in the region, China is the largest export market for Singapore, Taiwan Province of China, Thailand and the Republic of Korea in that order, and the second largest market for Japan and Viet Nam.

Figure 2. Percentage growth in exports to China for selected Asia-Pacific economies, 2010-2015



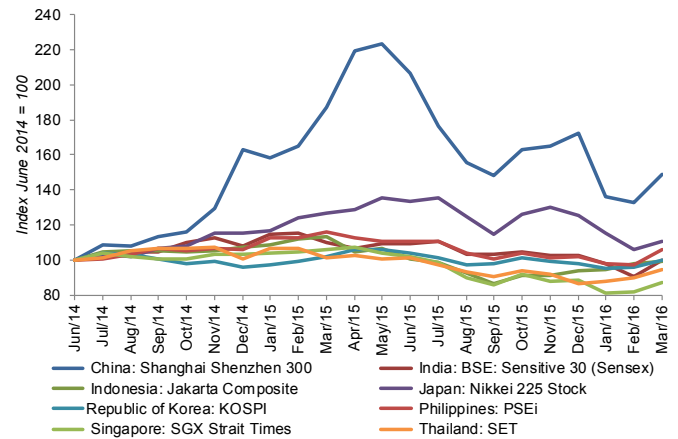
Sources: ESCAP, based on CEIC Data. Available from ceicdata.com (accessed 25 April 2016).

The impact on smaller economies or those with lower income levels is more noteworthy. For instance, in Mongolia almost 90% of all export shipments are destined for China. This makes the impact of a slowdown in exports to China, which constitute more than 40% of Mongolia's total output, very significant. In the Lao People's Democratic Republic, Turkmenistan and Viet Nam, exports of goods to China are also sizeable at 11-20% of those countries' GDP. Similarly, in Maldives where tourism is estimated to contribute directly to more than 40% of GDP, nearly one third of all tourists are from China.

The other major development in China with spillovers for the region has been significant volatility and depreciation in its currency in the past year. The main reason for this has been portfolio capital outflows due to investor concerns about weaker economic data from China and perceived related developments in the Chinese equity market. Decline in the Shanghai stock market in late 2015 and early 2016 spurred such concerns as they were interpreted by some investors as reflecting anxiety about the economy. However, it should be borne in mind that gyrations in the stock market do not necessarily reflect the state of the country's economy or its future outlook. For instance, when the stock market experienced a dramatic rise in the first half of 2015, China's economy was slowing down amid a slew of negative data. Furthermore, the Chinese stock market is by nature volatile due to the leading role played by retail investors, accounting for 80% of total participation. The frothy nature of stock markets is clear from the fact that the 40% decline in the equity market since its peak in mid-2015 still

returned the market to roughly the same value as it had been at the start of 2015. Nevertheless, the declines experienced by Asian stock markets in response to those in China reflect to some extent the strength of export linkages in the region with China and the belief that equity market falls in China are a sign of increasing concerns regarding growth in the economy (figure 3).

Figure 3. Equity market performance of China and selected Asia-Pacific economies, 2014-2016



Sources: ESCAP, based on CEIC Data. Available from ceicdata.com (accessed 25 April 2016).

Apart from market pressure for currency depreciation, government policy has played an important role in the renminbi's depreciation. As part of its economic rebalancing, in late-2015 China revised its currency exchange rate policy to reflect its trade relations more accurately. Specifically, the value of the Chinese currency is now based on a basket of currencies of China's main trading partners instead of being solely determined by the United States dollar. This change allows the renminbi to weaken more sharply against the dollar than in the past, which is especially pertinent in a period when the dollar is expected to strengthen as United States interest rates rise gradually. Indeed, between the announcement of the basket in December 2015 and 11 January 2016, while the Chinese currency weakened 2.5% against the dollar, the renminbi weakened only 0.9% against the basket. Previously, while in 2015 there had been pressure for the currency to depreciate due to capital outflows and weaker trade performance, the government had sought to maintain the previous currency peg against the dollar. As a result, foreign exchange reserves were used, leading to a fall in their level by \$513 billion in 2015.<sup>1</sup>

Other currencies in the region have also experienced significant depreciations. The decline in Asian currencies partly reflects concerns about export competition with China and other regional competitors. Uncertainty exists regarding the future direction of currency moves by China as the central bank has used its foreign exchange reserves significantly since the depreciation of early January 2016. Reserves fell by \$99.5 billion in January 2016 and \$28.6 billion in February to reach \$3.2 trillion, the lowest level since

December 2011.<sup>2</sup> This uncertainty regarding future movements in the renminbi will continue to be an important factor in determining the movements of regional currencies.

Given the importance of the Chinese economy to the region's economic prospects, ESCAP has attempted to quantify the potential macroeconomic impact of China's ongoing economic rebalancing on other emerging Asia-Pacific economies. In particular, the analysis has focused on three issues: (a) implications of a declining role of manufacturing activity in China on oil-exporting economies; (b) impact of increased uncertainty on stock markets that has coincided with China's growth moderation; and (c) assessment of possible currency competition, triggered by China's currency devaluation. To capture these aspects, simulation scenarios are constructed using the Oxford Global Economic Model. For the impact on oil-exporting economies, it is assumed that the volume of oil input used in industry, which is mainly determined by manufacturing growth, is 20% lower than the baseline levels during 2016 and 2017.<sup>3</sup> In the scenario on stock market movements, it is assumed that the magnitude of lower share prices in the region mimics what was observed during the sell-offs in the stock market of China in July-August 2015 and January 2016. Additionally, it assumes that the market risk premium rises while market confidence deteriorates as a result of more volatile economic conditions. In the scenario on currency movements, a 10% currency depreciation is assumed against the United States dollar in all major Asia-Pacific economies during 2016 and 2017.<sup>4</sup>

In the oil-exporting economies spillover scenario, the value of merchandise exports in Indonesia, Malaysia and the Russian Federation, the three major oil exporters in the region, is estimated to decline by 1.7%, 3.6% and 9.5%, respectively, during 2016 and 2017. The combined export loss in these three countries is valued at about \$34 billion over the two years relative to the baseline. Moreover, under the same scenario, the ratio of export prices to import prices in the Russian Federation is estimated to dip further to below 0.60 in 2016 and 2017 from 0.93 in 2014 and 0.72 in 2015. Such deterioration in the terms of trade would weaken that country's macroeconomic stability through depreciation pressure on the exchange rate, higher external debt servicing costs and higher inflation.

Regarding the capital markets spillover scenario, it is estimated that the annual GDP growth rates in India, Indonesia and the Republic of Korea are 0.9-1.0 percentage points lower than the baseline forecasts. In these three economies, annual real consumption could be 0.9-1.1% below the baseline levels, while fixed investment levels could decline by 1.3-2.3%. Under this scenario, loss in confidence in the capital markets translates into wider economic uncertainty. This in turn dampens economic growth through lower investment and consumption amid higher financing costs and weaker market sentiments.

Finally, in the currency depreciation spillover scenario, economic growth in India, Indonesia and the Russian Federation declines relative to the baseline. In India and the Russian Federation, while the weaker exchange rates help to improve the export of goods and services, the magnitude of the improvement is small, as the countries are either not export-dependent in the case of India or produce goods priced in foreign currency in the case of oil for the Russian Federation. In contrast, exchange rate depreciations push up inflation rather notably because of the higher prices of imported goods and services, thus constraining household spending. Overall, although currency depreciations may lead to some growth acceleration in export-oriented economies, such as the Republic of Korea, Singapore and Taiwan Province of China, the real output level in emerging Asia-Pacific economies as a whole is estimated to be nearly \$19 billion below the baseline during 2016 and 2017, given the below-baseline growth in large economies, such as India, Indonesia and the Russian Federation.

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<sup>1</sup> Reuters, "China FX reserves fall almost \$100 bln to lowest since May 2012", 6 February 2016. Available from [www.reuters.com/article/china-economy-reserves-idUSL3N15M037](http://www.reuters.com/article/china-economy-reserves-idUSL3N15M037).

<sup>2</sup> China Daily, "China FX reserves at lowest since December 2011", 7 March 2016. Available from [www.chinadailyasia.com/business/2016-03/07/content\\_15395687.html](http://www.chinadailyasia.com/business/2016-03/07/content_15395687.html).

<sup>3</sup> While large, this assumption is not unrealistic as a scenario. The volume of oil used by China's industry declined by 6.7% in 2010 and 0.5% in 2011 when the economy was still growing at 10.4% and 9.3%, respectively. The assumption also takes into account the Government's effort to promote greater use of non-fossil fuels and introduction of more stringent emissions standards.

<sup>4</sup> This assumption is relatively modest. The currency depreciations recorded in 2015 were between 2.5% and 8.5% in India, the Philippines, the Republic of Korea, Singapore and Thailand, and much larger at about 13% in Indonesia, 19% in Malaysia and 24% in Turkey.

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue was prepared by Shuvojit Banerjee. This policy brief benefitted from comments by Hamza Ali Malik. For further information on this issue, please contact Aynul Hasan, Director, Macroeconomic Policy and Financing for Development Division, ESCAP ([escap-mpdd@un.org](mailto:escap-mpdd@un.org)).