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Chinese Slowdown and Effects on Indian Economy

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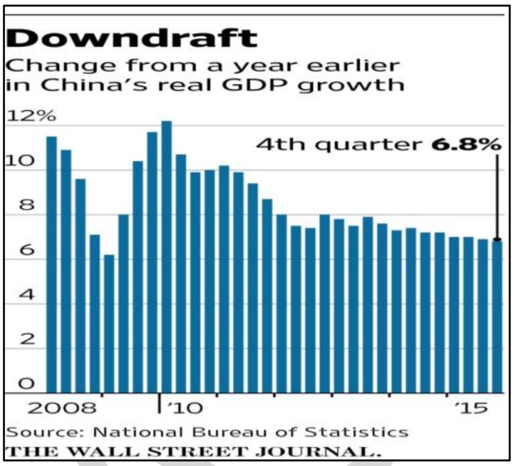
1. Introduction

- China recorded a pronounced deceleration in growth 2015, affirming that a multiyear slowdown is biting the world's second-largest economy harder and shows little sign of abating. The growth rate moderated to 6.8% for the fourth quarter and 6.9% for 2015.
- The annual pace was the weakest in a quarter century posting its lowest reading since the financial crisis and signaling weakening economic momentum.
- The stock markets have stumbled into the New Year, erasing gains from an unsteady recovery after a crash last year in August.
- Fears over slowing momentum in China and Beijing's handling of the economy have combined with concerns over plunging oil and commodity prices to pull down nervy global stock markets since the start of 2016. A more than expected growth decline in China will have negative effect on the world economy including India.

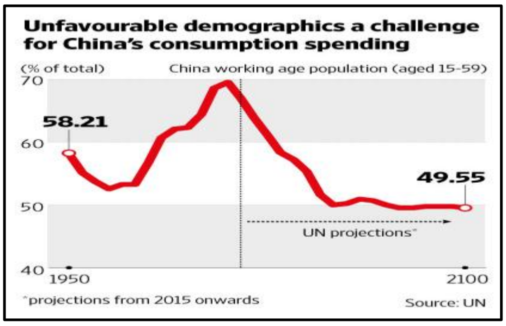


2. Economic Slowdown

There is no quick solution to China's troubles. The country is facing a lot of structural headwinds, starting with its export-led growth model.

2.1. Reasons of Slowdown

- **Decline in Exports**-: The recent decline in China's exports has arguably been an outcome of the 2008-09 crisis, which saw a decreased appetite for the country's products in the developed world. Official data also indicate that the recent decline in manufacturing activity is largely attributable to a decline in export orders.
- **Failure of the Structural adjustment-:** In the absence of domestic consumption demand, the government has periodically turned towards hiking investment spending, often financed by lenient bank credit. This has raised risks in sectors such as banking and housing and led to excess industrial capacity and a littering of ghost towns. As a result, China has negative producer price inflation (PPI).
- **Unfavorable Demographic pattern-:** As the working age population is shrinking in China due to its past policies there are no signs of expected rise in domestic demand. This has made the matter worse for Chinese economy.
- **Rebalancing of Chinese Economy-:** Chinese economy is rebalancing from exports and public investment to consumption, from manufacturing to services. This transition is associated with general slowdown as predicted earlier by experts.



2.2. Implications of Slowdown

A slowdown in China will undoubtedly have an impact on the rest of the world. That stems from not only the size of the Chinese economy, but also its earlier rapid growth and the model it adopted.

- **Decline in Commodity prices-:**
    - China's investment spree in the noughties meant it gradually became the largest consumer of major commodities. Chinese demand for commodities led to a sharp rise in global commodity prices in the 2000s, which has been often dubbed as the commodity price "super-cycle". For many commodity-exporting countries such as Australia, Brazil, and Indonesia this is going to be a tough time.
    - Australia's exports of iron ore and other minerals to China, its largest trading partner, have declined, raising fears of a recession.
    - In Asia, Indonesia saw coal exports plunge after China's economic challenges began to surface last year. Brazil, Peru and Venezuela also have suffered from commodity price collapses.
    - Many countries have linkages with Chinese industries. Countries like South Korea, the Philippines, Malaysia and Thailand are major exporters of industrial supplies and capital goods to China. It is likely to affect the economies of South-east Asia.

- **Oil Prices-:** Deceleration of growth in China has led to further fall in prices of crude oil and energy products. It resulted in reduced investment from perto-economies. Petro-states Saudi Arabia and Russia have taken massive hits from the collapse in oil prices, and are facing serious domestic financial challenges as a result. The two countries each export about 14 percent of their oil to China, according the Energy Information Administration.
- **Flight of Capital from Emerging Markets-:** Stock Market crash in China led to flight of capital from China as well as country expose to Chinese economy through trade relations. Capital is moving towards safe destinations like US treasury bills.
- **For China-:**
    - Trade as a proportion of economic output, for China, is expected to fall to less than 40% for the first time since the beginning of this century.
    - Small retail investors have been worst hit by the crash.
    - The foreign exchange reserves are falling sharply.

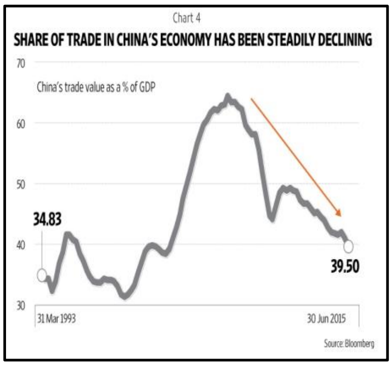
2.3. Response

- **Interest Rate cuts-:** PBoC slashed interest rates deeply; it relaxed the reserve requirements and cut interest rates five times since November last year. People's Bank of China (PBoC) reduced the share of assets that commercial banks must hold as reserves. Doing so gives institutions more leeway for lending, which is particularly beneficial to real estate and industry.
- **Currency Devaluation-**: PBoC also devalued Yuan multiple times from August 2015 to January 2016 to boost the exports.
- **Market Regulation**-: In attempts to shore up the market, China has banned selling by major shareholders. It has asked state-owned companies to buy stocks along with suspension of new listings.
- **Liberalizing pension fund investment rules-:** PoBC allowed state funds to put as much as 30% of their assets into domestic stock markets. This is expected to trigger a flow of investment cash into the Shanghai index, pushing values back up.

3. Effects on Indian Economy

Ever since the economic growth of China - India's largest trading partner in goods - started slowing down, concerns have been raised over its possible impact on the Indian economy. While it will be erroneous to argue that India will not be impacted by the economic churning happening in China, it will be equally irresponsible to suggest that India will be completely doomed if China falters.

3.1. Negative Impact



- **Export Fall-:** Exports are falling for last few months and they are expected to fall due to low demand. Decline of exports will depress India's economic growth.
    - Automobile exporters and manufacturers will feel the pinch as China was its fastest growing market for last couple of years.
    - Mining Sector is going to be hit most due to reduced demand from China.
    - Exports to developing countries exposed to Chinese economy are going to be affected by slowdown. E.g. Export to African, South-East Asia etc. will contract.
- **Dumping of goods-:** Yuan devaluation makes imports from China cheaper. This may lead to dumping of Chinese goods in India which will affect domestic manufacturers. Rubber, iron & steel sectors are going to be worst hit by dumping.

3.2. Positive Impact

- **Low Commodity Prices-** The lower commodity prices could work to India's advantage as it seeks to revive its own manufacturing sector and attract foreign companies to 'make in India'.
- **Deficit and inflation management-:** Oil prices were already taking a beating, with global slowdown and a possible US-Iran deal, China only nudged the prices lower. For India, low oil prices helps in controlling its deficit and keeps inflation under check.
- **Investment**-: India's big push for infrastructure development perhaps could get a boost from cheaper Chinese funds and resources. The development of India's high-speed rail network, renewable energy sector, smart cities and more importantly, the manufacturing sector, could become more feasible in the wake of reduced possibilities and opportunities for companies in China. Indian stocks, as a result, are reasonably valued despite their strong run, and could find it easier to attract foreign institutional investor (FII) money.

4. Way Forward

The impact of China's economic slowdown on India will be largely dependent on how the country proceeds on policy reforms. NITI Aayog Vice Chairman Arvind Panagariya has said that Indian economy can gain from the deceleration of the Chinese economy.

The urbanization of India and its swelling middle class will step in to fill the breach as China's economic growth slows. India needs to tread carefully to benefit from the current turmoil.

- Speeding up the key reforms to improve the ease of doing business indicators is important. Reforms that need immediate action.
  - Reforms in taxation namely GST and direct tax codes.
  - Bankruptcy Bill.
  - Labor reforms.
- Greater focus on skill development and manufacturing sector.

India should cushion itself to reduce the negative impact of a Chinese slowdown. At the same time, it should also explore the positive side of a Chinese slowdown.