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Is a Chinese shadow cast over Asia?

China is trying to find a way to achieve healthier, more sustainable growth, but this is not completely painless for its economy – or for those of its neighbours. According to Coface estimates, growth is unlikely to exceed 6.7% in 2015 and 6.2% in 2016, compared with 13.4% over the period 2006-2007. This is mainly a result of the technological and capital catch-up process running out of steam: several industries are suffering from overcapacity and corporate indebtedness is high, thus impacting investment. We are witnessing a shift in the Chinese economic model. Which Asian countries will be the first victims if there is a hard landing? And which will enjoy the greatest immunity?

The Middle Kingdom on the eve of major change

On-going change to the current Chinese model reveals two major developments: deteriorating price competitiveness in relation to other countries in Asia, and a transition to growth sustained by consumption rather than by investment.

The increase in unit labour costs, in part due to the fall in the working-age population, is causing a deterioration in price competitiveness requiring the country to move up the value chain. Foreign direct investment (FDI) in China has stalled in favour of more competitive countries (Thailand, Malaysia, Indonesia, and Vietnam). The contribution of investment to growth has become less significant, as evidenced by the gradual slowdown in the growth of fixed capital investment (11.2% in Q1 2015), in the profits reported by companies and in industrial production (6.3% on average per month between the beginning of the year and July 2015, against 8.3% in 2014).

Consumption is therefore playing a more important role in growth. This is supported by the Chinese authorities, who want to rebalance growth and make the economy more efficient by giving the market a greater role. In the long term, the Chinese economy's financial liberalisation is likely to offset the slowdown linked to the loss of price competitiveness, by supporting consumption and moving the country up the value chain. However, in the short term, the slowdown poses risks both for the domestic economy and for other countries in the region.

What is the risk of contagion for other Asian countries?

- **High risk of contagion** for financial markets and Mongolia

Hong Kong and Singapore are both very exposed to the slowdown in China in two ways. Firstly, through their financial markets, since their stock markets are highly correlated with the Chinese market and as a result of cross-border bank loans their banks are exposed to the deterioration in the creditworthiness of Chinese companies. Secondly, through trade, because the proportion of their exports to China in high risk sectors is significant: 74% of GDP in Hong Kong and 15% in Singapore.

Mongolia also exports very large volumes to China and is therefore likely to suffer from its slowdown and is doubly penalized with a negative price effect (high risk exports represent 43% of GDP). Impacted by lower commodity prices, as well as lower Chinese investments in related sectors, it will suffer a fall in the volume of demand for minerals, metals, and fuels.

- **Moderate contagion**: Thailand, Malaysia, Indonesia and Vietnam

Financial and trade exposure in this group of countries is significant because the proportion of exports to China is high. However high risk exports represent less than 10% of total GDP. They are therefore sufficiently solid to avoid their growth derailing if the Chinese economy manages a soft landing: a 10% fall in these countries' exports to China would lead to a loss of growth of less than one point in these economies. Finally, these countries benefit from China's declining competitiveness and consequently are seeing an increase in FDI.

- **Countries with the greatest immunity**: India and the Philippines

Trade relations between these countries and China are limited, as are the risks of financial contagion. They also benefit from the fall in commodity prices. India could suffer later however, through a rebound effect if the Gulf countries turn out to be affected by China's slowdown. The Philippines may be affected by the low wage gap with China. But only a sharp slowdown undermining the recent increase in labour costs in China could have a noticeable effect on FDI in the Philippines.

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