GROWING UNCERTAINTY

MIKE WATERS, CEO OF SOR INC. IN LENEXA, KAN.
PHOTO BY GARY BARBER

Evaluating the slowdown in China's economy

China's economic slowdown has caused worldwide concern.

Venezuela, which heavily exports to China, faces a recession due to China's reduction in fossil fuel exports. Oil producers such as Russia and the Organization of the Petroleum Exporting Countries also feel the sting of oil price volatilities—in part due to China's decrease in demand. Russia exports about 15 percent of its oil to China.

South American countries such as Brazil and Argentina also face financial woes as China's appetite for agricultural commodities tapers. And African and Asian countries face economic uncertainties due to China's cutback in manufacturing, which heavily relies on those continents' natural resources, such as iron ore and copper.

First-quarter turmoil in the financial markets also concerns investors. South Africa, one of China's main trading partners, recently saw its currency, the rand, plummet in value, and Chinese policymakers in late February tried to reassure trading partners that it can manage market stability while implementing structural economic changes without devaluing the yuan.

For now, the U.S. economy remains somewhat insulated from China's slowdown because of diversification. But for how long, especially in the Tenth Federal Reserve District, which has a large presence in China's energy, agricultural and manufacturing sectors?

China's economy

Jun Nie and Nicholas Sly, senior economists at the Federal Reserve Bank of Kansas City, say China's economy is transitioning to a "new normal" that relies more heavily on domestic consumption and less on traditional channels such as exports, real estate investment and government investment. During this transition process, China has experienced a few developments that rarely happened before, such as the large capital outflows in the last couple of years.

Trade linkages are how many assess China's influence on the global economy. As China reduces imports from core industrial countries and emerging economies, it affects countries that receive exports from China.

"In contrast, the Chinese financial sector has been historically isolated from the rest of the world due to tight capital controls, limiting the impact of Chinese capital flows on the global economy," the economists said.

This, however, has changed in the last year as the Chinese government relaxed capital controls and eased restrictions on capital leaving the country in 2014 and 2015. In that same time span, China experienced five consecutive quarters of record-level capital outflows for the first time since 2000. The outflow is mainly in loans—China increasing loans to the rest of the world and foreign loans withdrawn from China. Direct foreign investment, however, is another source of China's capital outflows.

Tracking the destination of the loans and direct investments is difficult due to the lack of statistical information on China's financial account—the country's balance of payments that covers claims on or liabilities to nonresidents in regard to financial assets.

Nie and Sly say loans leaving China account for about 40 percent of the country's capital outflows. They were able to gather data on direct investments by observing cross-border merger and acquisition activity. What they found is a sharp increase in U.S. inbound acquisition activity from China.

"In the last half of 2014 and first half of 2015, U.S. inbound acquisition activity from China spiked to more than three times its historical average," the economists say. "In other words, a portion of the capital flowing out of China recently has been absorbed by real investment within U.S. industries."

Usually, capital flowing out or leaving a particular economy often signals there is instability in that particular economy. In this instance, the capital outflows not only show China's economic slowing, but reflects the strength of the U.S. economy to absorb the outflows.

The World Bank forecasted China's economic growth at 7 percent in 2015, after double-digit growth for several years, and small slowdowns are expected to generate from 6 to 7 percent growth until 2017.

Jeremy Hoge works on one of the automated machines in the machine shop at SOR Inc. The company, based in Lenexa, Kan., is one of the leading manufacturers of high-quality pressure and level-measuring instruments. About 30 percent of SOR's business is in exporting instruments to China.

PHOTO BY GARY BARBER

Nie and Sly caution that if China's slowdown is larger than currently expected and U.S. industries and financial markets continue to absorb China's capital outflows, then "investors will need to compete more aggressively for viable domestic opportunities."

Although this could lead to more domestic projects being funded, bolstering greater U.S. investment activity, it could also lead to markets underpricing risks associated with less attractive investment opportunities.

China's affect on the Tenth District

Although the U.S. economy as a whole can absorb the shocks of China's "new normal," the economic slowdown will affect regional businesses.

Andres Kodaka, a research associate at the Kansas City Fed, said China's slowdown could have a direct impact on Tenth District states that export goods to that country.

For example, China was Nebraska's second largest export market in 2013. Nebraska exported more than $1.9 billion in goods and services to China, including meat products, construction machinery, oilseeds and grains, according to the Nebraska Business Roundtable. Nebraska's exports to China grew by 21 percent in 2013; however, the amount of growth has tapered since then.

Also, China is Colorado, Kansas and Missouri's third largest export market, after Canada and Mexico. The states' exports included a variety of sectors, from chemicals, wood, and computer and electronic products to transportation equipment, beverages and tobacco products.

Although China's share was 7.6 percent of Missouri's total exports, well under 1 percent of the state's total GDP, China still generates more than half a billion dollars in revenue. Colorado generated $745 million in exported goods and services to China in 2013, which was a continuation of nine years of extraordinary growth in trade with China.

Kodaka said China made up 9.9 percent of Kansas' export business. In the first half of 2015, the state's exports to China totaled $762.4 million, less than the $1.2 billion and $895.6 million exported to Canada and Mexico, respectively.

Exports to China from Missouri, however, declined 0.4 percent from the first quarter 2014 to the first quarter of 2015, while total exports for the state increased 3 percent. Colorado experienced a 7.6 percent decrease in 2014, although exports overall increased more than 3 percent. Kansas was the one state that experienced a decline in both exports to China and its total exports, 4.2 percent and 8.7 percent, respectively.

"This larger overall decline in Kansas exports is likely a symptom of the recent strengthening of the dollar since Kansas exports more commodities, which are sensitive to changes in currency exchange rates," Kodaka said.

Adapting to China's 'new' economy

In January 2014, one U.S. dollar was worth 6.5 yuan. As the dollar strengthens, the rate could increase to between 6.8 and 7.5 by mid 2016, analysts say.

"Those are dramatic changes when it involves the commercial competitiveness of our products sold into China," said Mike Waters, CEO of SOR Inc., based in Lenexa, Kan.

SOR manufactures devices that measure pressure, temperature, level and flow, and the company maintains offices in London, India, Dubai and China. The products SOR sells to China focus on the fossil fuel power-generating sector.

Waters says his company has seen a slowdown in some of China's traditional economic drivers after years of double-digit investment growth.

"As power building and new infrastructure has slowed in general, and as fossil power has declined as a percentage of overall generating capacity, it has had a material impact on our business in that region," Waters said.

It's a simple matter of supply and demand. Much of China's economic growth was

Kansas City Fed Senior Economist Jun Nie constructed a model to evaluate the Chinese government's estimated GDP growth. His model predicts China's growth slightly less than the official estimate.

investment growth, Waters said. The Chinese government invested in building power plants and now has excess capacity—more power than currently needed.

"We've taken note of some of the overt messaging from the Chinese government that they wish to diversify their economy and create a larger services sector and de-emphasize the manufacturing element," Waters said.

This shift to a more "normalized economy" changed SOR's commercial strategy in China.

"We now are more aware of the country of origin of our competitors on large project tenders and we are incorporating the currency exchange rate in our commercial strategy to a much greater extent than one to two years ago," he said.

About 30 percent of SOR's total revenue comes from Chinese exports. And like China's GDP growth, SOR approached double-digit revenue growth in Chinese exports for several years. The next couple of years, however, the company expects the margin to flatten.

Although China's economy will slow down—the state government projected 6.8 percent GDP growth in 2015, and projects 6.5 to 7 percent for 2016—the economy is still strong.

"It's just not growing in the sectors that have a demand for our products," Waters said.

China wants to move toward nuclear power generation and invest in chemical and petrochemical production.

"We're looking for more diversification for our in-use segments, such as nuclear power investment."

SOR also will participate more in the chemical and petrochemical markets as China decreases its use of fossil fuels.

"We still anticipate China to be our largest export market for years to come," Waters said. "Some of our other markets may have higher growth rates than China, but would be nowhere near the volume."

Evaluating the strength of the Chinese economy

Despite the financial turmoil and manufacturing slowdown, China's consumers appear more optimistic about their own economy than the rest of the world, and according to Nielsen's fourth-quarter 2015 survey, most Chinese consumers seem unaware of the economic turmoil.

Health and work-life balance seem to be on their minds more than a slowdown in manufacturing, says Louise Keely, president of the Demand Institute and the lead author of Nielsen's quarterly global survey on consumer confidence.

According to the survey, Chinese consumers trust their government to deliver on its promise of improving quality of life as it moves China to a "new normal."

Keely says the optimism may have something to do with the state's tight control of the media and keeping the economy out of the news. Or growth in the service sector is offsetting the decrease in construction and manufacturing.

Either way, consumers are still spending money. Nielsen says 86 percent of Chinese consumers surveyed report using digital payment systems for online purchases, which has boosted the state-owned monopoly China Union Pay into the world's third-largest credit card network.

Nie, however, cautions against reading too much into any one particular economic measure, such as the relatively stable consumer spending or the slowing industrial production, when gauging China's economy.

"Gauging the strength of the Chinese economy is difficult, as many market participants are skeptical about the official Chinese GDP numbers," Nie said.

Nie says, however, his recent research findings show that the official Chinese GDP numbers seem to capture the overall strength of the economy.

Nie constructed an index using a series of key sector data from China's economy, which are not directly reflected in state's official GDP statistics. The index can provide an indirect check of the country's headline GDP estimate.

In particular, the model uses economic indicators on manufacturing activity, consumer spending, the real estate sector and the services sector. The data goes from the fourth quarter of 2008 to the fourth quarter of 2014.

The model predicts a growth rate slightly below China's official GDP estimates for 2015, but suggests that growth remained stable. The deviations from the model's GDP estimates and China's official estimate, Nie said, can be largely attributed to the Chinese stock market's rapid growth last year, partially driven by monetary easing and government support.

But given the current cooling equity market, Chinese growth may face additional downward pressure. For example, if the contribution to GDP growth from finance returns to its average level recorded from 2000 to 2015, the contribution of the finance sector to GDP growth will be 0.6 percentage points smaller in 2016 than 2015, Nie said.

"The finding highlights potential risk to the Chinese growth outlook in the near term," Nie said. "The unwinding of the unsustainably large contribution from financial services could create a significant drag on Chinese GDP growth."

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KEVIN WRIGHT, EDITOR

FURTHER RESOURCES

"Gauging the Strength of Chinese GDP Growth" by Jun Nie
www.KansasCityFed.org/~/media/files/publicat/research/macrobulletins/mb16nie0229.pdf

"Global Capital Flows from China" by Jun Nie and Nicholas Sly
www.KansasCityFed.org/~/media/files/publicat/research/macrobulletins/mb15niesly0908.pdf

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