Talking point

Renminbi impact on Germany low, but not Chinese cyclical risks

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For the average German a sack of rice falling over in China has long been none of his business. In the meantime, however, the importance of events in China for the German economy has come to be recognised. China's unexpectedly weak economic indicators and the fluctuations in the Chinese stock market have increased the scepticism over recent months about whether China will achieve the growth target set by the government for this year of around 7%. Our China economist remains confident that the Chinese economy will stabilise following expected GDP growth of nearly 7% yoy in Q3 thanks to the support measures instigated by the government. However, German exporters are already having to contend with a marked softening of demand from China. In May exports were down 9.3% yoy, though this was partly due to a basis effect (+17.7% in May 2014, over the last 3 months +1%). But German firms manufacturing in China have also felt the weak demand, above all carmakers which have faced a year-on-year decline in Chinese demand for cars of almost 1.5% during the last 3 months.

On Tuesday the Chinese central bank altered the fixing of the exchange rate, which had hitherto been restricted to a +/-2% fluctuation range relative to the US dollar. The fixing of the exchange rate is now geared more closely to market conditions. The initial outcome was a raising of the midpoint in the +/-2% band against the dollar by 1.83%. The reaction on the spot market necessitated a further hike in the band of 1.6% on the following day and another 1.1% increase on Thursday. The Chinese currency is currently trading at USD 6.39 and is thus nearly 3% lower than at the start of the week. The fact that the Chinese central bank is attempting to prevent the renminbi from depreciating too much by making verbal statements and intervening in the foreign exchange markets supports the presumption that its action primarily constitutes a transition to a more market-based rate setting process, which is intended to help the renminbi develop into a global reserve currency. Despite the partially significant drop in exports (year on year) supporting the Chinese export sector appears not to be an important motive – although probably not unwelcome. Presumably the devaluation will slow over the next few days. This is also backed up by the central bank's assertion that expectations of a devaluation totalling 10% are “nonsense”.

Impact on the German economy of an assumed 10% devaluation

In order to estimate the potential impact on the Germany economy we nevertheless assume a total devaluation of 10% against the US dollar. Although China accounts for only 11% of the trade-weighted exchange rate for Germany calculated by the Bundesbank, the currencies of other emerging markets – especially in Asia – have also softened. If the countries affected are added to the equation, then around 20% of the effective exchange rate is probably affected. Assuming 10% devaluation against the dollar – potential fluctuations in the USD/EUR rate are ignored in this case – the nominal, effective value of the euro would appreciate by just 2%.

Assuming an average price elasticity of export demand of 0.3 (it is probably actually slightly lower due to the composition of exports to the emerging markets), German export growth is likely to be just 0.6 of a percentage point (pp) lower due to the exchange rate effect. If correspondingly lower imports of intermediates are also factored into the equation, the effect on GDP amounts to about ¼ pp. The effect on the inflation rate is likely to be even lower at 0.1 - 0.2 percentage point.

Risks to the Chinese business cycle are more serious

This assessment is based – as mentioned – on an exchange rate effect alone and relies on assumptions that are highly uncertain in part. A more pronounced economic slowdown in China would be more noticeable than the devaluation. A Bundesbank simulation model estimates that if Chinese GDP growth were 2.3 pp lower than in the baseline scenario, German GDP growth would probably be 0.3 pp lower (eurozone -0.2). No negative confidence effects are simulated in the model. The slower growth is likely to materialise mainly via the export channel, which would correspond to roughly a 10% drop in German exports to China. In such an event investment activity in

Germany would of course probably be affected via confidence effects. Moreover, the simulation was based on the assumption of a still-stable exchange rate. This assumption is unlikely to be maintained on account of the policy change in China. This means that the overall effect is likely to be much more pronounced than computed by the simulation.

However, we do not expect – as mentioned above – any sustained weakening of the Chinese economy. The currently appreciable impact on our conservative estimates for net exports and investment in plant and machinery is thus likely to be at least partly offset. In Germany we thus remain trapped in a scenario in which robust domestic demand remains at odds with dampening effects from the global economy.

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