Why the Chinese economic slowdown may benefit Canada

By Daniel Lacalle
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In recent months, analysts and market commentators have voiced concerns about a slowdown in the Chinese economy. The general view is that growth significantly below the current level of 6 per cent to 6.5 per cent would be bad for the global economy, posing the risk of modest deflation or even becoming a drag on economies around the world – legitimate concerns.

It's important to note, though, that the slowdown in China has nothing to do with the trade war headlines. It was a reality before trade negotiations with the Trump administration became so aggressive. China's economic growth pattern is changing rapidly – and for the better.

The country's highly indebted model of growth at any cost and its dependence on commodity imports were ultimately unsustainable. The world does not need another financial crisis triggered by excessive debt.

It is not an emerging economy any more, and as such we should not expect the gross domestic product (GDP) increases of the past years. The new economy is more consumer- and service-based, as opposed to one based on heavily industrialized capital and commodities. Such an economic model, driven by dynamic and innovative companies, not by state-owned, inefficient enterprises, cannot offset in GDP terms the massive infrastructure and debt-fuelled investments of the past decade.

China now faces three challenges: excessive total debt, estimated at 270 per cent of GDP; overcapacity; and significant financial imbalances in a large group of state-owned enterprises that generate returns below the cost of capital. Addressing those issues and incentivizing the technology and services sectors means a less energy-intensive GDP, a lower rate of growth and a gradual, lengthy transition to a more open economy that ends its capital controls.

A lower growth rate means more sustainable development, as China's energy intensity is expected to halve in the next 20 years. That is good news for the world – for its resources and for the climate.

It also means lower inflation for the rest of the world. China exports disinflation to other countries in two ways: by selling cheaper products and because all the capacity installed around the world to supply the allegedly endless needs of China starts to become unnecessary. These two factors have been quite evident in the past three years, as we saw the effects of the 2008 Chinese stimulus, which created larger imbalances and excess capacity.

There is also a monetary factor involved. The significant imbalances built into the Chinese economy throughout the past two decades – exacerbated by that misguided stimulus – may require a significant devaluation of the yuan. Beijing understands that the outcome of excess capacity and debt traditionally ends with a financial crisis and a rise in unemployment. In order to avoid this painful outcome, it can rebalance the economy by devaluing the yuan and allowing the currency to float. Of course, this would also have negative effects, but it may be perceived as easier than taking hard measures to reduce leverage.

However, imbalances of such magnitude are not addressed solely with monetary policy. As we have seen since the financial crisis, low interest rates, liquidity injections and beggar-thy-neighbour currency wars have only increased global debt to all-time highs.

Devaluation is rarely a tool for improvement or an easy way to address competitiveness challenges; it just perpetuates the inefficiencies of the economy as it transfers wealth from the savers and productive sectors to the less productive and more indebted parts of the economy – in effect, a subsidy for the unproductive at the expense of responsible citizens.

In the case of China, it is not a "competitive" devaluation that is required, but a free-floating currency. China cannot aspire to be a global leader with a widely used currency and also maintain capital controls. China has the second-largest economy in the world, but the yuan is used in less than 5 per cent of global transactions, according to the Bank of International Settlements. That is why China needs to let its currency achieve a market value relative to its other trading currencies that is closer to reality; otherwise, its economy's dependence on the U.S. dollar and risky, commodity-backed loans will create a bigger problem.

None of these issues was new before the "trade war," but if anything, the tension between the United States and China has highlighted the severity of these problems and has driven Beijing to boost its promotion of innovation and debt control and speed up the transition phase to the new economy.

How does this benefit Canada?

One of the things that often infuriates me when I analyze the Canadian economy is reading so many reports that categorize Canada as a commodity-driven economy dependent on Chinese growth. Along with Australia, our country seems to be incorrectly perceived solely as a commodity proxy.

Canada imports much more from China than its exports to the Asian giant. An economic slowdown, disinflation and switch to a consumer- and service-based economy in China clearly benefits Canada, as we import cheaper products and export added-value ones such as technology.

China's growth slowdown will not spell the end to its need for oil and natural gas; it will just moderate its requirements. Additionally, it will need cleaner energy. This is a particularly positive turn for the Canadian natural gas sector and its liquefied-natural-gas segment. It is also a fabulous opportunity for renewables and infrastructure developers, which can compete with China through technology, value and service. Canadian technology and expertise in developing non-conventional sources of energy are highly likely to be in demand in the new China.

Co-operation will be key. China will need a strong partner that supports its transition to a modern, thriving economy. For Canada, the Chinese market simply cannot be ignored as a platform for growth in services, technology, infrastructure and manufactured goods. The new China is likely to demand much higher-quality goods and services, strong brands and superb customer experiences. Even in a slower-growth economy, we cannot underestimate the opportunities presented by a thriving Chinese middle class.

What are the biggest challenges? The depreciation of the yuan, disinflationary pressures and slower growth should not be an issue if Canadian companies do not fall into the trap of requiring high inflation and extremely high growth rates to sustain their business with China. Working capital kills more companies than any other risk, and the energy industry in Canada learned quickly and painfully how to adapt to a lower-for-longer oil price environment. Oil and gas producers managed to survive and deliver, halving their break-even oil price when most analysts believed the industry would not survive. That same principle should be applied to the opportunities in the new China.

The only businesses that should be worried about the Chinese slowdown are those that are

too leveraged to adapt to a normalization of China's growth pattern. Sectors that adapt to a changing world and see that China's future is brighter without its massive imbalances will be the winners. China slowing down its growth can easily mean Canada accelerating its own. It just requires a different perspective: Less excess, more value.

Daniel Lacalle is an economist whose books include Life in The Financial Markets, The Energy World Is Flat *and* Escape From the Central Bank Trap. *He is currently working on his next book,* Freedom or Equality – The Key to Prosperity Through Social Capitalism.