more give, less take

China Economic Update

by NAB Group Economics

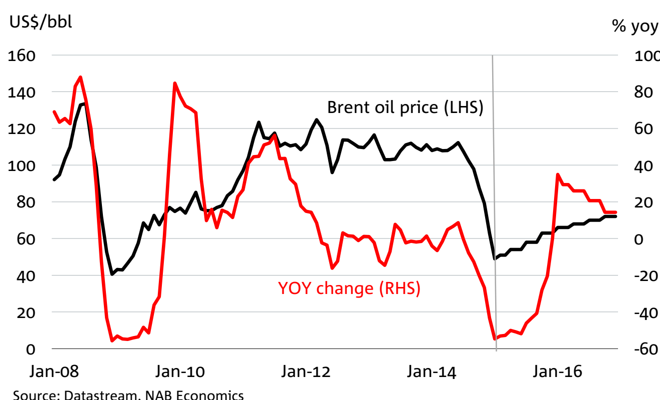
12 February 2015

How much will China benefit from the falls in oil prices?

Since early 2014, global oil prices have plummeted, falling by 55% year-on-year to around US$48 a barrel in mid-January (for benchmark Brent crude). As the world's second largest oil consumer (behind the United States) and largest net importer, China stands to benefit from sustained lower oil prices. Lower fuel costs should allow Chinese consumers expand other spending, while Chinese firms can take advantage of lower input costs to boost profits, reduce debt and/or build market share. That said, there is some uncertainty as to how large the benefit will be.

Oil prices are expected to remain comparatively low in the short term. NAB forecasts Brent prices to average US$56 a barrel in 2015 (a fall of around 43% from last year), before moving back up to US$69 a barrel in 2016.

Oil prices have fallen sharply since late 2014, and are forecast to remain comparatively low



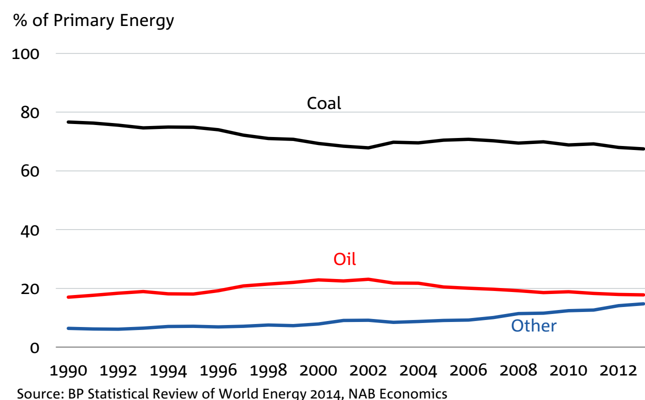
Source: Datastream, NAB Economics

China's place in the global oil industry

China's oil consumption has risen strongly across the last two decades, driven by the country's rapid industrialisation. In 2002, China overtook Japan to be the world's second largest oil consumer. That said, oil's share of China's primary energy consumption has declined since this time – from 23% in 2002 to 18% in 2013 – as other energy sources have grown more rapidly.

In contrast, oil comprised almost one-third of global primary energy consumption in 2013, and 37% of consumption in advanced economies. Compared with other major economies, China is far more reliant on coal – with coal providing over two-thirds of the country's primary energy needs in 2013.

Coal continues to dominate China's energy mix, with oil retreating slightly since 2002



Source: BP Statistical Review of World Energy 2014, NAB Economics

In 2014, China's crude oil imports totalled US$228 billion – accounting for almost 19% of the country's total imports by value and around 2.5% of total GDP. Sustained lower oil prices will therefore reduce China's financial outflows, providing a significant boost to the economy.

Economic impact of lower oil prices

A range of studies have attempted to determine the impact of oil price movements on China's economy – primarily analysing the impact of price increases and volatility that was the norm over the past decade. These studies typically follow methodology first used to assess the impact on advanced economies, particularly following the major oil crises of the 1970s.

For example, Cong (2013) constructed an economic model that showed a 10% increase in oil prices could reduce output growth by almost 0.4% – albeit the study used industrial value added as a proxy for economic activity. Assuming that the economic impacts of equally sized increases and decreases in oil prices mirror each other, this would imply a boost to China's economy of 1.6% from NAB's 2015 oil price forecast.

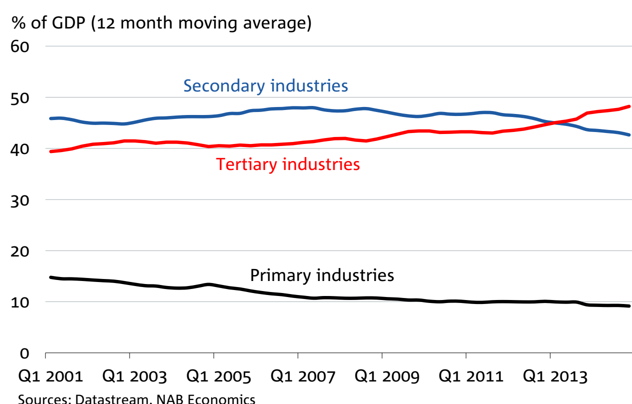
A more recent research piece by Bank of America-Merrill Lynch produced a much smaller estimate – a 10% fall in annual crude oil prices would boost growth by 0.15%. This would imply a smaller economic gain – over 0.6% increase in the growth rate (based on our oil price forecast).

This outcome was closer to the results produced by International Monetary Fund (IMF) simulations, released in December 2014. In these simulations, China's growth increases by 0.4% to 0.7% in 2015 (compared with the baseline). Despite the boost to growth from lower oil prices, the IMF revised down their forecasts for China's growth in January – to 6.8% in 2015 and 6.3% in 2016 (from 7.1% and 6.8% previously forecast in October 2014).

Why is there such a considerable range in these estimates?

China's economic evolution produces some challenges in attempting to model the impacts of these changes. In order to effectively model a relationship between oil prices and economic growth, it is necessary to have a relatively long time series. However, China's economic model is changing – with less momentum provided by energy intensive heavy industry and investment and more from low intensity services (as has been the case in advanced economies across recent decades). This means additional units of economic output are less sensitive to oil price movements than in the past.

Energy intense industries losing share in China's GDP – services growing faster

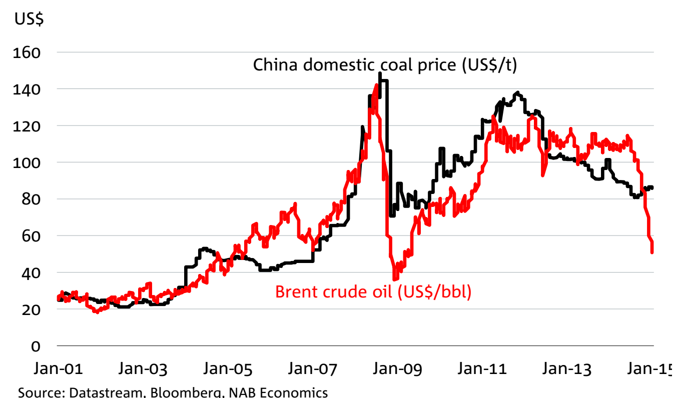


Sources: Datastream, NAB Economics

In addition, China's economic growth is less export dependent than it was in the 1990s and early 2000s. This means that second round effects, improving consumption in other oil importing regions (such as the United States and Europe) will provide less benefit than would have been the case in earlier periods.

Secondly, these studies often use oil prices as a proxy for energy prices more generally. As noted above, China's energy mix is dominated by coal, rather than oil, with the large majority of coal being domestically produced. Domestic coal prices fell in 2014 – albeit not nearly as significantly as oil prices. Further downward pressure on coal prices is likely to be limited by the poor profitability of the domestic industry – therefore the full estimated flow through benefit from lower energy prices is unlikely.

China's coal prices have fallen less significantly than oil – energy prices still elevated



Source: Datastream, Bloomberg, NAB Economics

Ceteris paribus – will the Government allow the full benefit to flow through?

A critical issue that will influence China's growth prospects is the policy response from authorities. Modelled results often rely on the assumption of ceteris paribus – that all else is equal – whereas China's government may view lower oil prices as an opportunity to drive through reform.

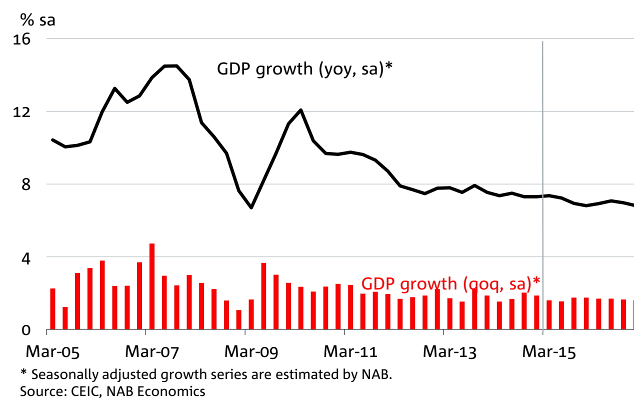
This is the view of the IMF, who argue that authorities will attempt to reduce the vulnerabilities resulting from the rapid credit and investment growth across recent years. The recently lowered forecast assumes that there will be a minimal policy response to the moderating growth trend.

What do we expect?

Unlike the IMF, we have revised up our forecasts for China in both 2015 and 2016, although only modestly, with a 0.1% upward revision in both years – to 7.1% in 2015 and 6.9% in 2016. We expect that Chinese authorities will take advantage of the oil price stimulus to lower public investment and continue the process of cleaning up shadow banking (and with it credit growth more generally).

This upward revision is quite conservative (when compared with the modelled benefits above), however we continue to expect a slowing track for China's growth – particularly given the political capital invested in announcing a 'new normal' of slower growth.

China's growth trends to continue to slow



* Seasonally adjusted growth series are estimated by NAB.
Source: CEIC, NAB Economics

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