

Euro macro notes

The China connection: short-term boost, long-term worry

- **Chinese pent-up demand could boost euro area activity during the summer of 2023, but also create new inflation concerns for ECB. Tourism will likely be the main channel, while the scope for higher goods exports seems more limited.**
- **Amid rising geopolitical tensions, European companies are reconsidering their ties to China, but we do not expect any abrupt changes. China remains a leading supplier of rare earths and many technologies that will be key for a successful green transition of European industry.**

Chinese re-opening provides important silver lining

China's exit from its zero-Covid policy happened faster than we previously expected and on the back of a stronger growth outlook (see *China Outlook: Earlier reopening to drive faster rebound*, 3 January), we see scope for Chinese pent-up demand to boost euro area activity during the summer of 2023.

Before pandemic restrictions hit, the Chinese were quickly becoming the largest group intercontinental travellers. Tourist arrivals from China to the euro area have been on a steady uptrend, reaching a peak of 11.3mio in 2019 (from 2.2mio in 2008). While more and more Europeans are also travelling to China, tourism is one of the few sectors where the EU has a positive balance of payments with China, meaning the EU is a net exporter of travel services to China. Tourism constitutes a sizable part of the euro area services economy, especially for Southern European countries like Spain or Greece, where tourism receipts accounted more than 10% of GDP before the pandemic.

Chinese pent-up demand has not only the potential to boost services activity, but also have positive spillover effects for f.ex. consumer goods and retail sales. Chinese tourists travelling to Europe on average spend more than three times (EUR 227) what the average traveller does (EUR 66), and have even overtaken American visitors on their spending. This is partly explained by the fact that many Chinese see Europe as a single destination, visiting three to four countries per trip. Although Chinese travel spending may not return immediately to pre-pandemic levels, we think the euro area economy could still get a boost in the summer of 2023, in the magnitude of 0.2-0.3% of GDP.

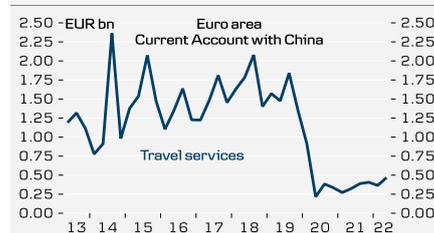
The Chinese government has vowed to support the private sector in 2023, and increased investment activity not least in the tech sector and manufacturing could have positive spillover effects on euro area investment goods exports to China. That said, the upside potential seems limited. China has become a net exporter of machinery and transport equipment to the euro area in recent years. Cars sold in China are increasingly manufactured domestically and as China has become a leader in EV battery technology, domestic brands have seen their market share steadily increasing at the expense of European manufacturers. Combined with relatively robust Chinese car sales even during the pandemic, all this makes a significant boost to euro area car exports to China unlikely in our view.

Chinese rebound could provide short-term boost to euro area activity



Source: Markit, Macrobond Financial, Danske Bank

Room for Chinese tourism to recover



Source: Eurostat, Macrobond Financial, Danske Bank

Chinese exports of machinery and transport to Europe have risen



Source: Eurostat, Macrobond Financial, Danske Bank

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A blessing and a curse...

Despite the positive growth implications, the Chinese reopening also risks worsening the inflationary dilemma for the ECB. Rising demand from Chinese tourists could worsen the pressure on staff shortages in the travel industry, and increased hiring efforts could further stoke wage inflation. Furthermore, China's economic rebound will also revive its demand for commodities, creating upside risks for energy inflation. China and Europe will increasingly compete for supplies on a tight global LNG market. In December, IEA already warned of a 27bn cubic metre shortfall in EU gas supply in 2023, if gas deliveries from Russia drop to zero and China's LNG imports rebound to 2021 levels. Despite the recent decline in natural gas prices below pre-war levels, with regard to the energy crisis, Europe continues to move on thin ice.

'Strategic autonomy' considerations make China no longer a one-way bet

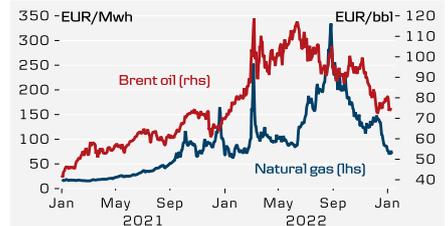
Beyond the short-term boost from the Chinese rebound, the war in Ukraine has also raised some more structural questions about EU-China relations. Since 2019, the EU has pursued a three-pronged approach to China as systemic rival, economic competitor and partner in areas of common interests such as climate action.

With Europe's rapid energy decoupling from Russia already weighing on the economy, the EU is unlikely to enact even more damage by cutting its trade and investment links to China in a hurry. That said, Europe's bargaining position also has improved in light of growing US-China tensions, with Beijing keen to adopt a less threatening posture towards Europe for fear of pushing it even closer to the US. In an attempt to mend fences, Chinese President Xi met with German Chancellor Scholz and European Council President Michel in November. However, China's 'charm offensive' seems to have had limited pay-offs so far and Chinese investments in critical technologies and infrastructure face increasing headwinds in Europe.

Amid a more benign political climate, China has lately focussed its investments in Central and Eastern Europe. Among euro area countries, particularly Germany stands out in its economic exposure to China. China remains Germany's largest trading partner, accounting for 9.5% of goods trade in 2021 and nearly half of German manufacturers rely on intermediate inputs from China (three-quarters for car industry). Sino-German trade supports more than one million jobs directly and millions more are indirectly linked to it. Of Germany's ten most valuable listed companies, nine derive at least 10% of revenues from China (compared to two in America).

Waking up to the reality of Russian energy blackmail, Germany's growing China dependencies have started to raise questions among politicians and 'Mittelstand' firms increasingly realise that they cannot rely on Chinese profits as they once did. The government's new "China Strategy" (which will be released in the coming months) will likely include clear messages on the need to reduce dependencies and diversify supply chains and trading partners. Berlin has already signalled it will offer fewer guarantees to insure companies against political risks in China. A new due diligence law, which makes larger companies responsible for monitoring human rights violations by their suppliers, could also dissuade German investment in China. That said, deep divisions persist between the Greens and parts of the SPD about the future of the relationship, as last year's controversy regarding Chinese shipping company Cosco's acquisition of a stake in a Hamburg container port terminal underlined (China already controls 10% of European port throughput capacity).

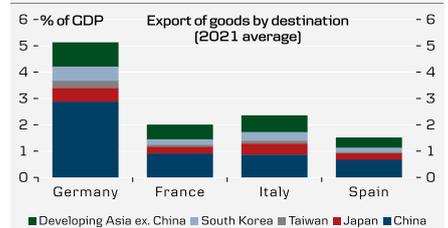
Upside risks to commodity prices



Source: Bloomberg, Macrobond Financial, Danske Bank

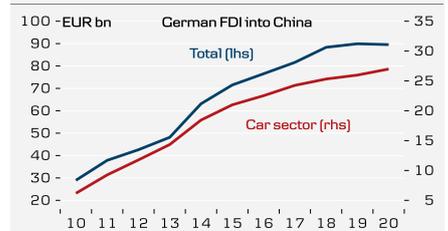
Note: Past performance is not a reliable indicator of current or future results.

Germany stands out in its economic exposure to China



Source: IMF, Macrobond Financial, Danske Bank

German FDI into China has stagnated, but continues to increase for car producers

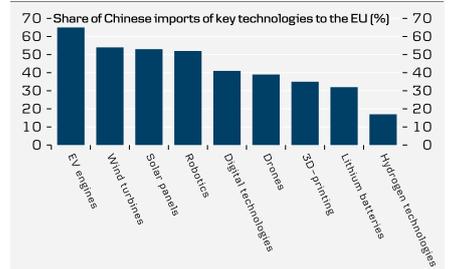


Source: Bundesbank, Macrobond Financial, Danske Bank

Amid growing concerns about China’s sabre-rattling over Taiwan, many companies are taking a closer look at their China dependencies. According to *Ifo Institute*, nearly half the German manufacturers that receive significant inputs from China plan to reduce their Chinese imports, with 80% citing ‘diversification of supply chains and the avoidance of dependencies’ as the key reason. However, a more nuanced picture emerges at the sectoral level. While many SMEs are looking to diversify their supply chains away from China towards other EU or EM countries, Germany’s old industrial giants remain reluctant to leave the Chinese market.

Overall, European companies leaving the Chinese market in droves remains unlikely, given the attractiveness of its still rapidly growing consumer base. China remains a leading supplier of rare earths and many technologies that will be key for a successful green transition of European industry. That said, the days of China being a one-way bet are gone. A successful diversification of European industry into alternative suppliers and export markets will be an important building block for future proofing the growth model, but it also leaves upside risk for more persistent inflation pressures from ‘efficiency losses’ during the transition phase.

China plays key role in green transition rare materials and technologies



Source: EU Commission, Ifo

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