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Australian shares rocked by China rout, but economic fundamentals remain solid

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Australia's securities exchange has been rocked by China's sharemarket, following the 8.45% free fall of the Shanghai Composite Index, with a 4.1% rout of its own, the largest one-day sell-off since the height of the global financial crisis in 2009. But is Australia's China connection really that dire?

Fortunately, the markets' convulsions and the realities of the relationship are very different.

First, China's sharemarket may be in free fall; but its economy is not.

Big fluctuations in the sharemarket have never reflected the state of the broader economy. That was true when the Shanghai Composite Index surged by 130% between last August and this June. And it has remained true as it has fallen by nearly 40% since then.

When China's market bubble burst a couple months ago, consumer confidence was undented. That's because stocks only account for around 10% of household wealth.

It is the case that China's secondary sector - manufacturing and construction - isn't doing well. The latest indicator of manufacturing activity was firmly in contraction territory and exports, mostly manufactured goods, were down by 8.3% in July, compared with a year ago.

But that's far from a full picture of China's economy, which is now driven by the tertiary sector, or services. In 2014, services accounted for 48% of GDP, compared with 42% for manufacturing and construction combined.In the first half of this year services grew by a robust 8.4%. And the most recent services sector indicator leapt in July.

Might China just be making these numbers up in an attempt to look good?

That's unlikely because the services indicator noted above is an independent gauge, not one that is published by China's National Bureau of Statistics. The evidence also suggests that China's second quarter GDP numbers released last month were broadly credible.

As far as the impact of China on Australia's economy goes, its important to focus on the fundamentals. The overarching macroeconomic changes taking place in China are a slowing growth rate – 7% growth in 2015 will be the lowest in 25 years - and a rebalancing in the structure of demand away from investment towards household consumption.

It's these themes that have some convinced that the best days of the Australia-China economic relationship are over.

It's hard to spin slowing growth as a positive and while the rise of household consumption might be welcomed by Australia's agricultural and services sectors, mining is unlikely to be so enthusiastic.

Chinese parents want to buy their children high quality milk and a world-class education, not steel girders. Yet it's mining that still accounted for 66.4% of Australia's exports to China last year.

Research by the Reserve Bank of Australia (RBA) in 2014 estimated that one dollar of Chinese investment involved more than double the demand for Australian value-added output compared with a dollar of Chinese household consumption.

But slowing growth in percentage terms doesn't mean that China's economy will be adding fewer dollars. In fact, because the economy has become so large, last year more dollars were added than ever before. If China grows by 6.9% this year another record will be set. It is these new dollars that will buy more beef from Kilcoy and holidays on the Gold Coast.

Rebalancing away from investment also won't happen overnight. Investment may shrink as a proportion of the economy but if the pie keeps getting bigger the demand for iron ore from the Pilbara could still increase.

For all the doom and gloom about China's construction sector, in the first seven months of 2015 Australia's exports of iron ore exports to China were still up by 13%. And that's coming off a record high in 2014.

It's instructive to try to stitch all this together to see how things might pan out.
Start with the IMF's new growth forecasts, released earlier this month, which have China growing at 6.8% this year, falling to 6.3% in 2020.

Then suppose that the growth of real consumption spending in China outpaces real investment spending such that the household consumption share of GDP increases by one percentage point each year out to

2020. That is, the consumption share increases to 43.7%, up from 37.7% now, while the investment share falls from 46% to 40%.

Finally, use the RBA's numbers to get a rough idea of how this will affect demand for Australian goods and services.

This is the result: between 2014 and 2020, China's demand for Australian value-added output jumps by 37%. Put another way, this demand grows at nearly double the expected pace of the Australian economy overall.

But what happens if China's growth only averages 3%, a rate that even the perma-bears might regard as a bit too conservative? In that case, China's demand still goes up by 13%.

Of course, any simulation is based on a set of assumptions that may or may not eventuate, and parameter values that can always be debated.

But the key point is this: it takes a very pessimistic scenario for the tailwind that China has been providing economic activity in Australia to turn into a headwind.