

China: What happens when the free greenbacks dry up?

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Outline

Section 1

Global economic outlook

Section 2

The FED exit

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Impact on Emerging Markets: What is it for China

Section 4

Conclusions for China

Global Economic Outlook

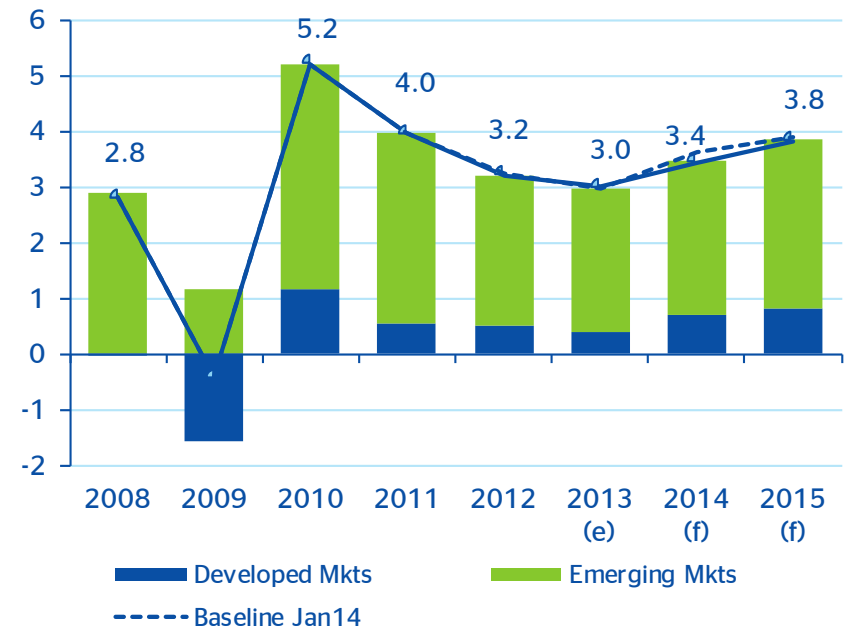
- 1 **Global expansion moderating with China growing less** than previously expected and without immediate risks of a sudden adjustment

- 2 The combination of the **Fed tightening and (further) adjustments of China's growth** will be the dominant factors in the coming months (absent an ECB's QE) with an heterogeneous impact on EM

Global GDP growth

(%)

Source: BBVA Research



Monetary Policy & Capital Flows

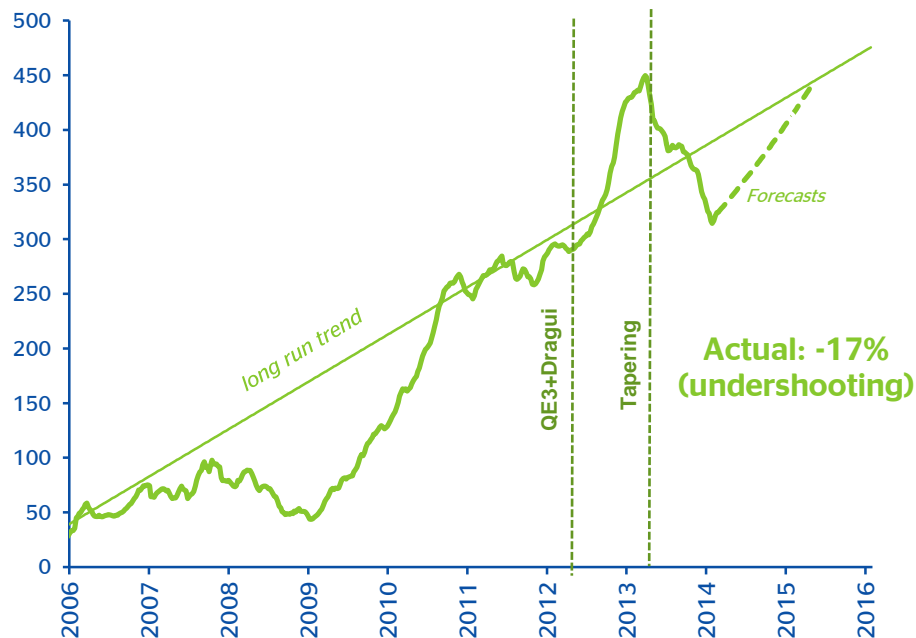
5 In any case, **EM Portfolio Capital Flows** are still below equilibrium and should start to navigate to their long run trend

6 After being particularly penalized by the US tapering **Emerging Asia** will follow this path too

Emerging Asia: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

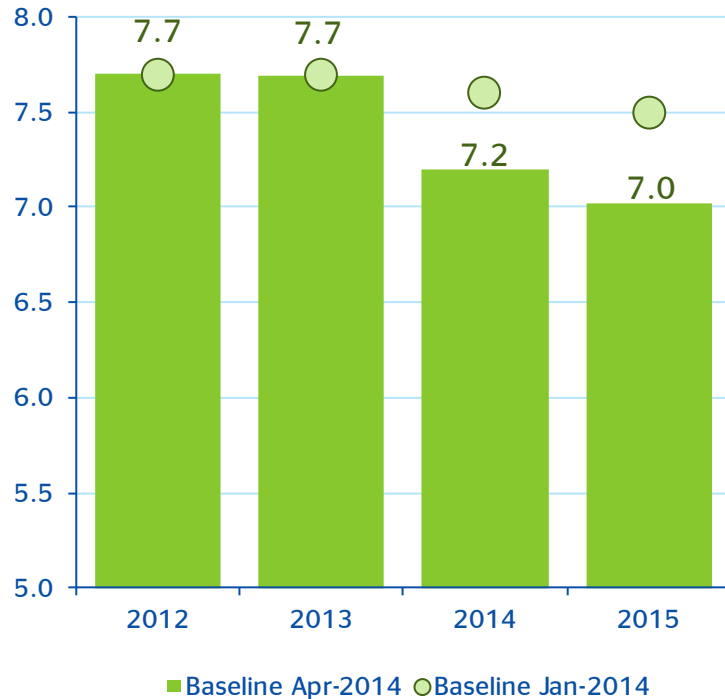
Source: BBVA Research, IMF and EPFR



China: Updating our baseline scenario due to poor incoming data and new assumptions on economic policy

China: GDP Growth (% , y-o-y)

Source: BBVA Research



The government will press ahead with reforms and implement measures to curtail financial risks

We expect a higher adjustment in investment than in consumption

Policy supports from public expenditure (infrastructure investment, tax reliefs) would be implemented if domestic economy loses momentum below the bottom line of 7.0%

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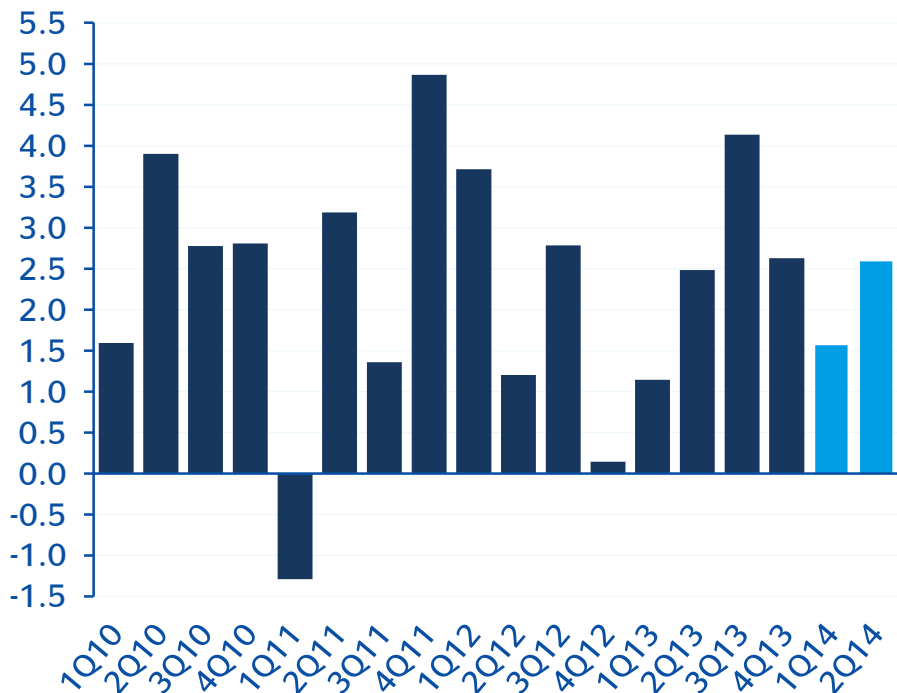
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The US Tapering is already here and signs of economic improvement are materializing...

US: GDP Forecast, QoQ SAAR % change

Source: BBVA Research



Source: BBVA Research

The rebound after the winter months is more evident, particularly in consumption.

However, weaker global demand and some housing sector pressures are limiting the pace of expansion.

Job growth is not expected to accelerate significantly in 2014 and inflation is expected to increase slowly.

We maintain our baseline scenario mostly unchanged (2.5% GDP growth for 2014 and 2015), slightly elevated upside risk to GDP growth

US monetary policy: Fed funds scenario unchanged, risk tilted towards an earlier rate hike

	Latest	What do we expect?	Policy pause until
Fed	<p>FOMC Statement: April 29-30, 2014</p> <ul style="list-style-type: none"> Monthly pace of asset purchases tapered to \$45bn - spread to \$20bn in MBS and \$25bn of Treasury securities Forward guidance left untouched bringing back unanimous FOMC vote <p>Changes to FOMC voting members by June 17-18 meeting.</p> <ul style="list-style-type: none"> Two incoming Governors, vice-chair Fischer and Brainard, will likely be in place to vote, one Governor, Stein, leaving Centrist voter, Pinalto, Cleveland FRB, will be succeeded, by likely hawkish Mester 	<ul style="list-style-type: none"> Measured steps of \$10bn reduction of QE3 Course of policy firming remains data dependent Anticipated changes to June projections on “pace of policy firming” due to new, incoming FOMC members FOMC likely to introduce further modifications to the forward guidance throughout the policy normalization process 	<p><u>Mid - 2015</u></p> <p>Maintaining the 3Q15 baseline but with lower likelihood as the probability of early rate hike increased</p>



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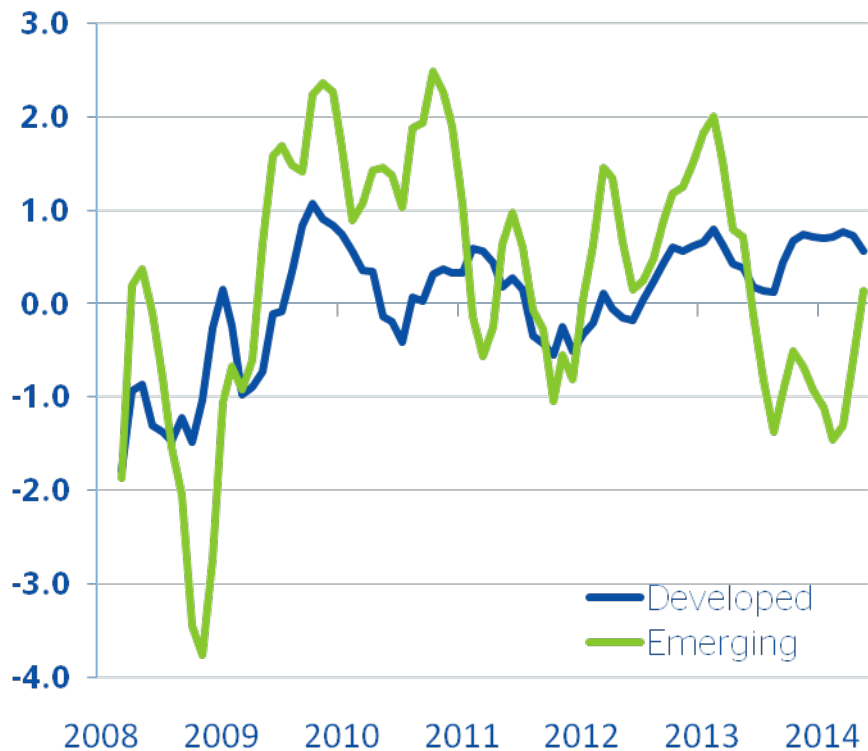
Conclusions for China

QE tapering at first dramatic for EMs but improving

Net Portfolio Inflows : Developed vs Emerging

(Country Flows over Total Assets, moving average 3 months)

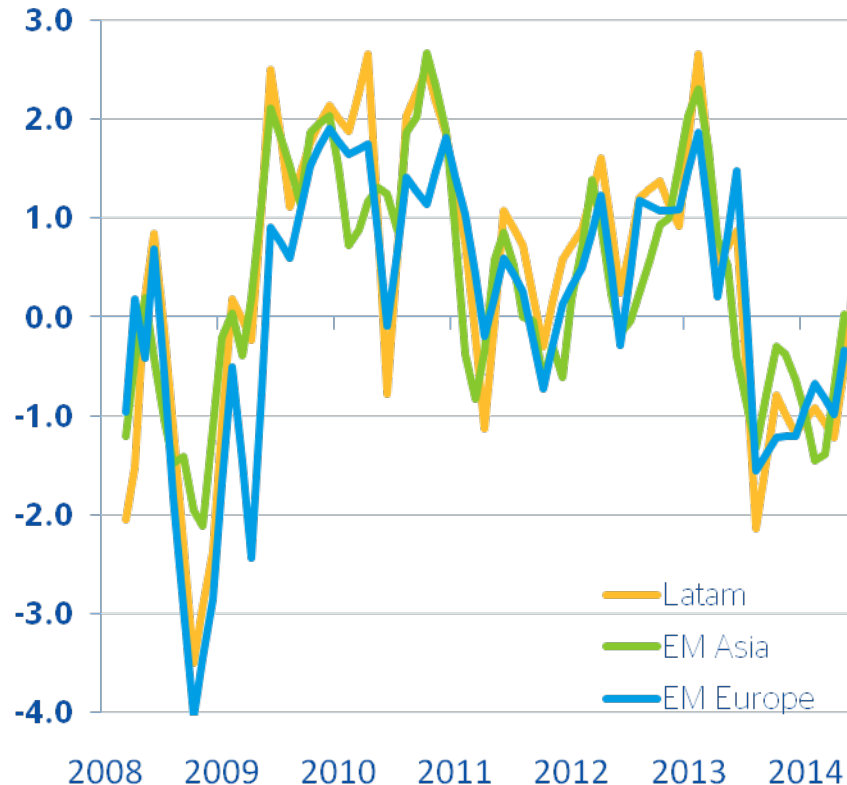
Source: EPFR and BBVA Research



Net Portfolio Inflows : Regional Emerging Mkts

(Country Flows over Total Assets, moving average 3 months)

Source: EPFR and BBVA Research

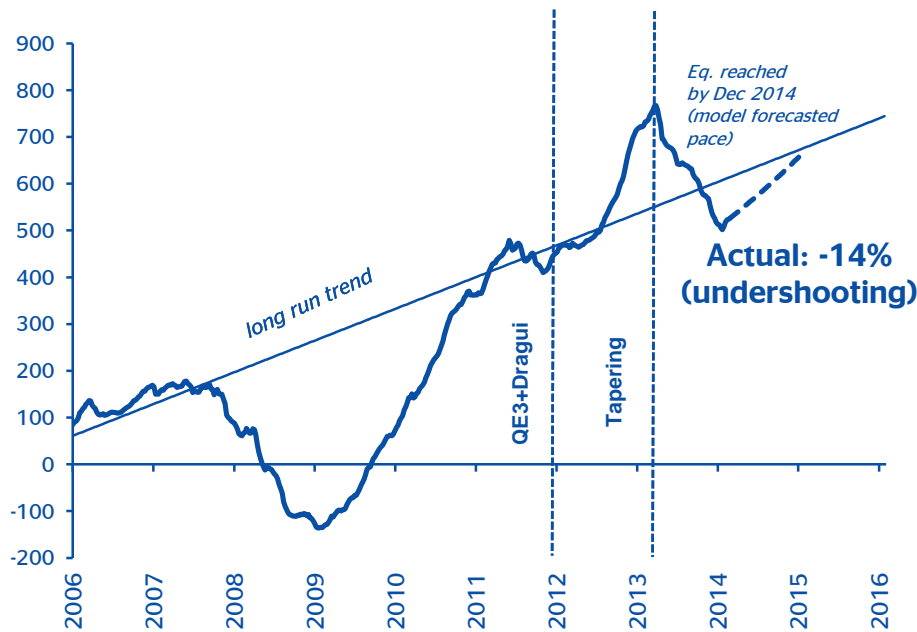


Path of recovery strong but should moderate

Emerging Markets: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

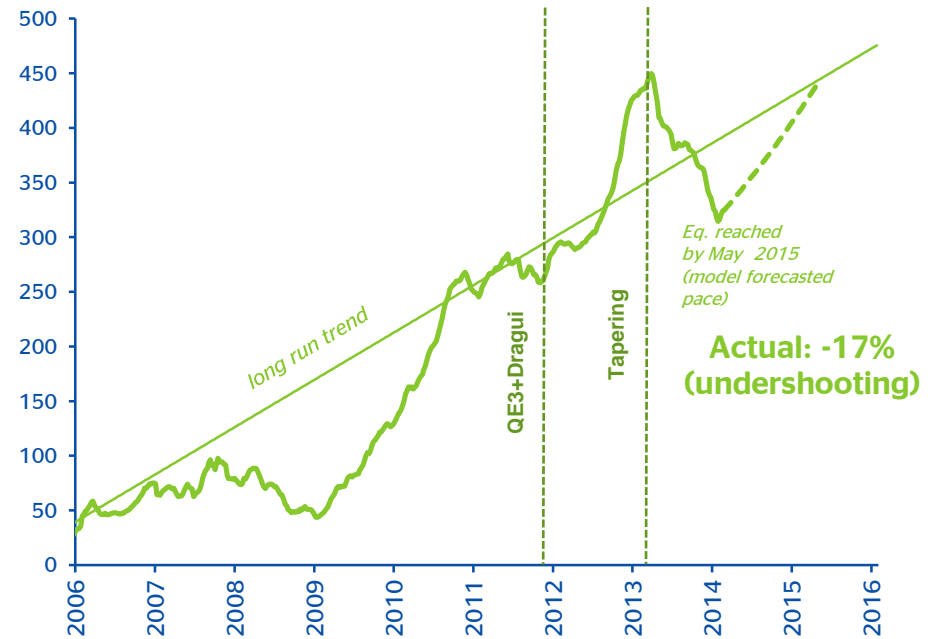
Source: BBVA Research, IMF and EPFR



Emerging Asia*: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

Source: BBVA Research, IMF and EPFR



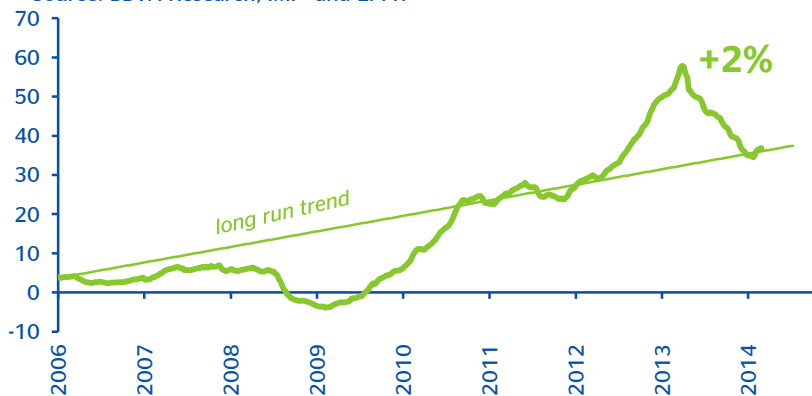
(*) Includes: China, India, Indonesia, Philippines, Thailand, Korea, Taiwan, Hong-Kong and Singapore

Asymmetry in capital flows adjustment remains...

Turkey: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

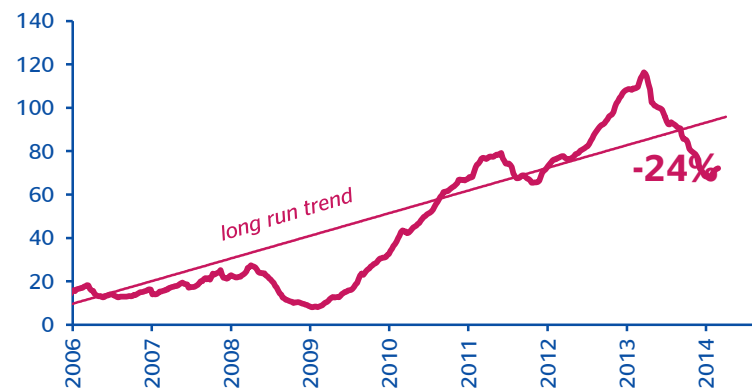
Source: BBVA Research, IMF and EPFR



Russia: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

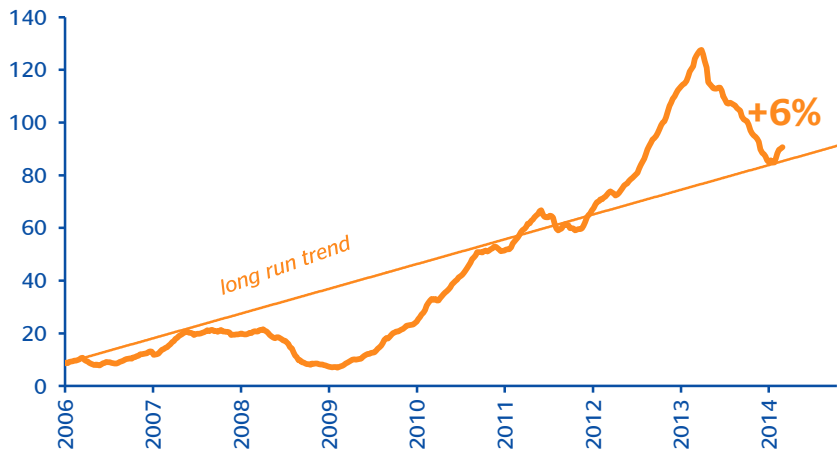
Source: BBVA Research, IMF and EPFR



Mexico: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

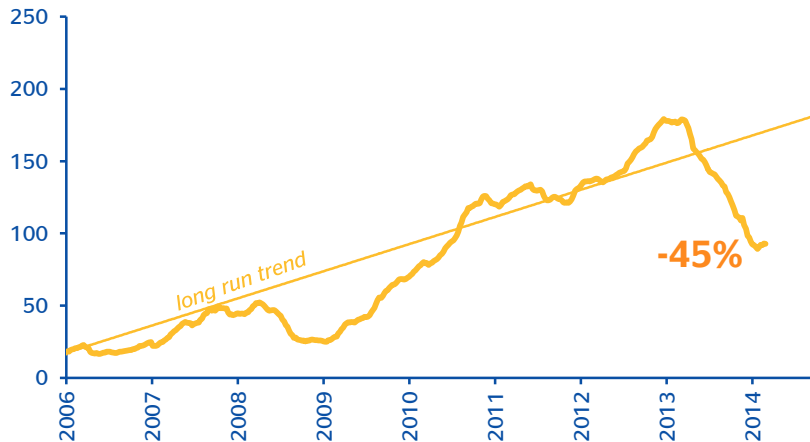
Source: BBVA Research, IMF and EPFR



Brazil: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

Source: BBVA Research, IMF and EPFR

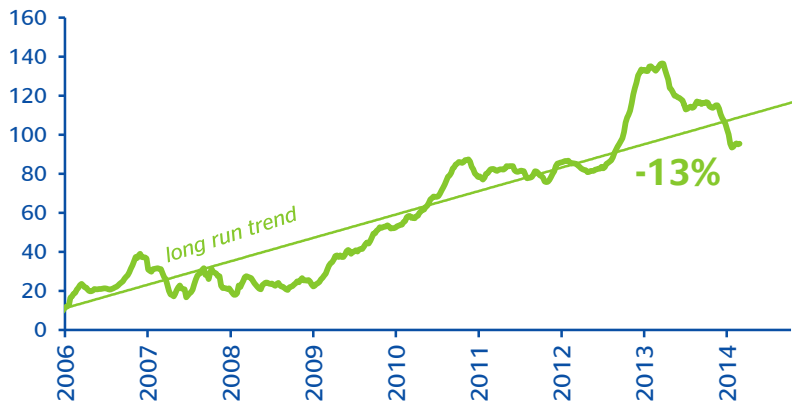


... with a some particular “damage” to Asia...

China: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

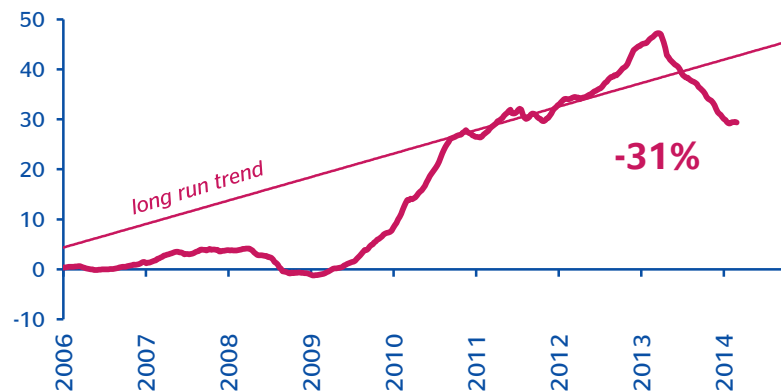
Source: BBVA Research, IMF and EPFR



Indonesia: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

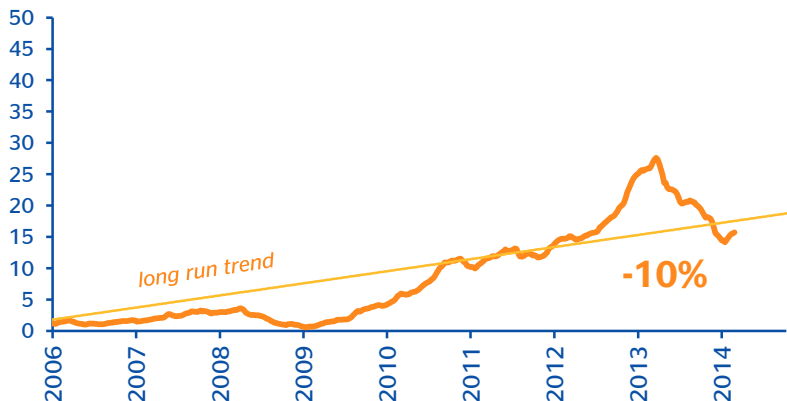
Source: BBVA Research, IMF and EPFR



Thailand: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

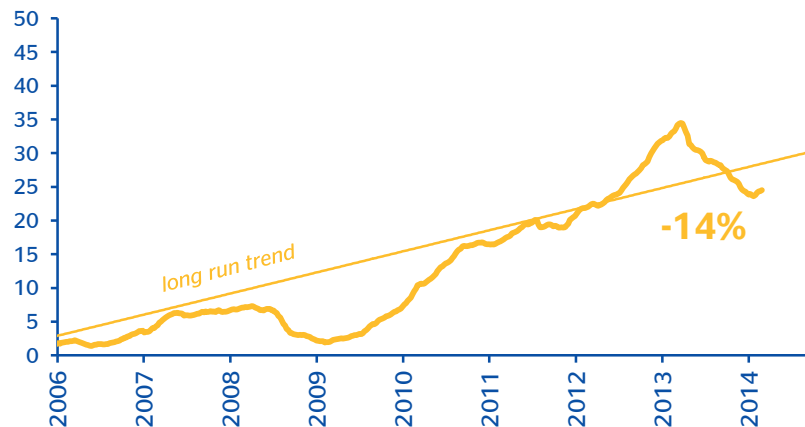
Source: BBVA Research, IMF and EPFR



Philippines: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

Source: BBVA Research, IMF and EPFR

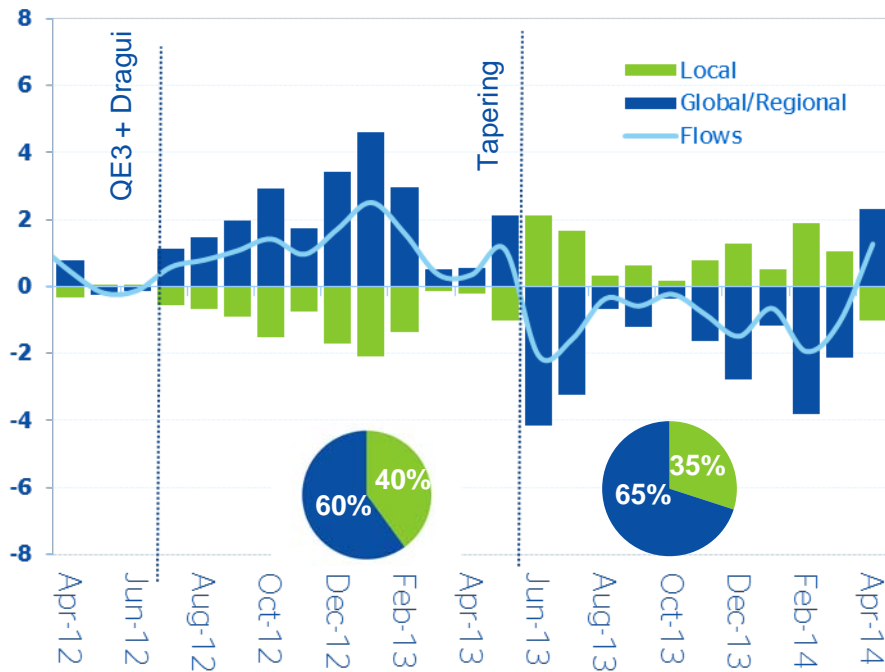


Global Factors dominant when tapering started... increasing role of domestic factors thereafter

Emerging Markets: Total Net Portfolio Flows Drivers

(External (Global and Regional) + idiosyncratic)

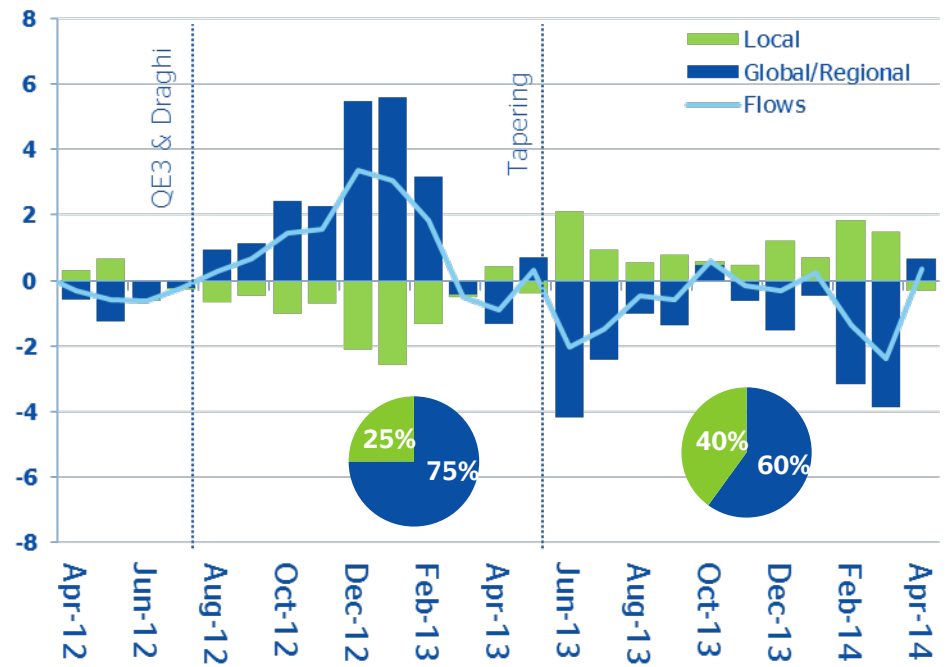
Source: BBVA Research



China: Total Net Portfolio Flows Drivers

(External (Global and Regional) + idiosyncratic)

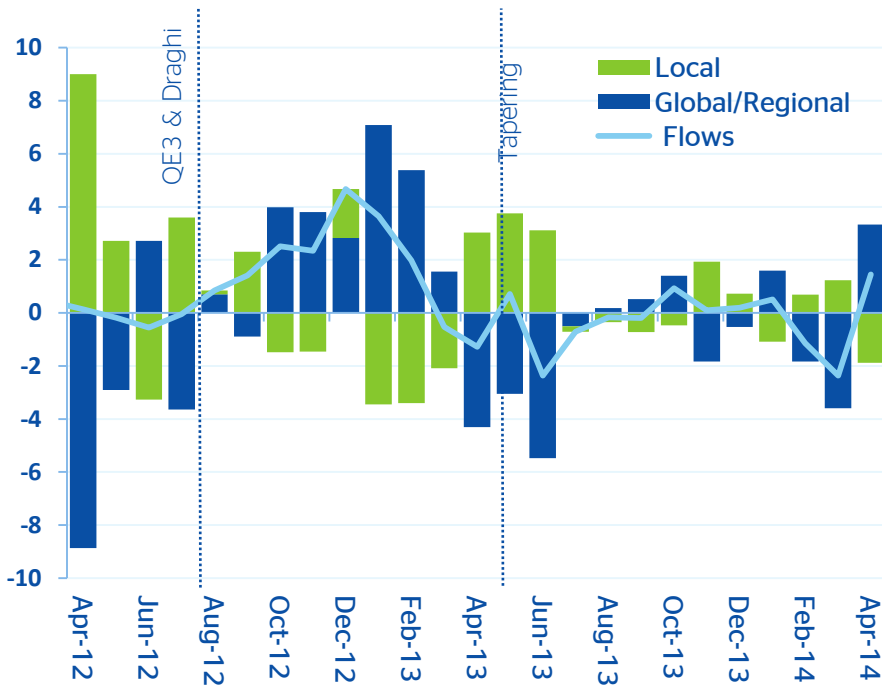
Source: BBVA Research



In China institutional flows recovering

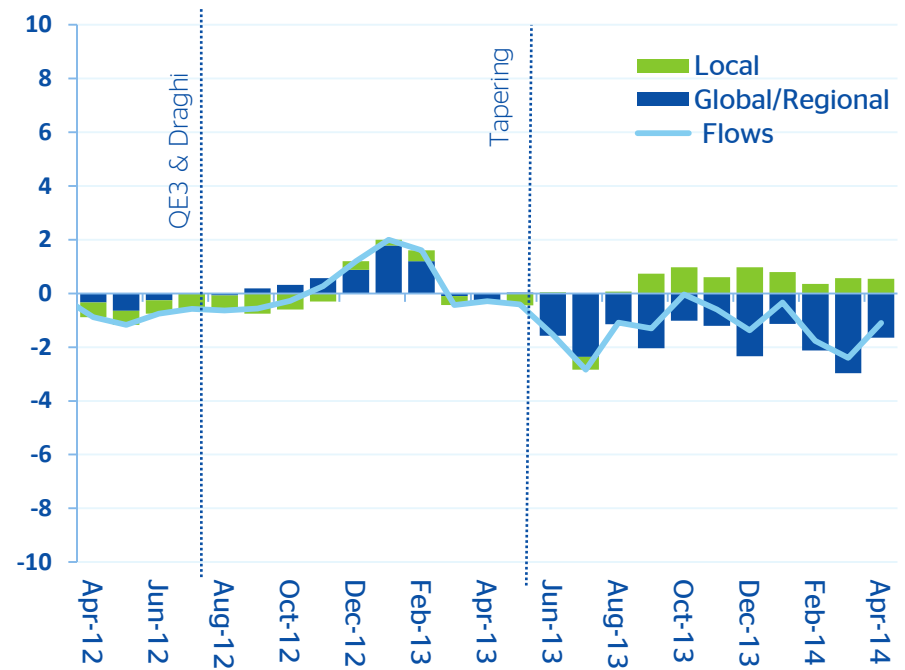
China: Institutional Net Portfolio Flows Drivers (External(Global and Regional) + idiosyncratic)

Source: BBVA Research



China: Retail Net Portfolio Flows Drivers (External(Global and Regional) + idiosyncratic)

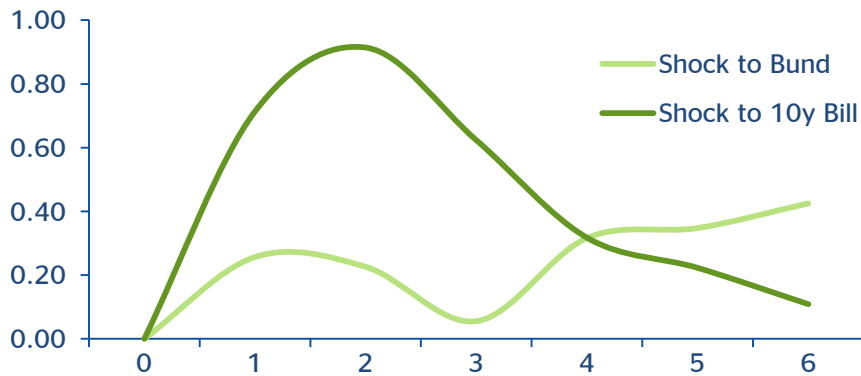
Source: BBVA Research



Impact of QE tapering seems bigger in China than in rest of EM (especially for bonds)

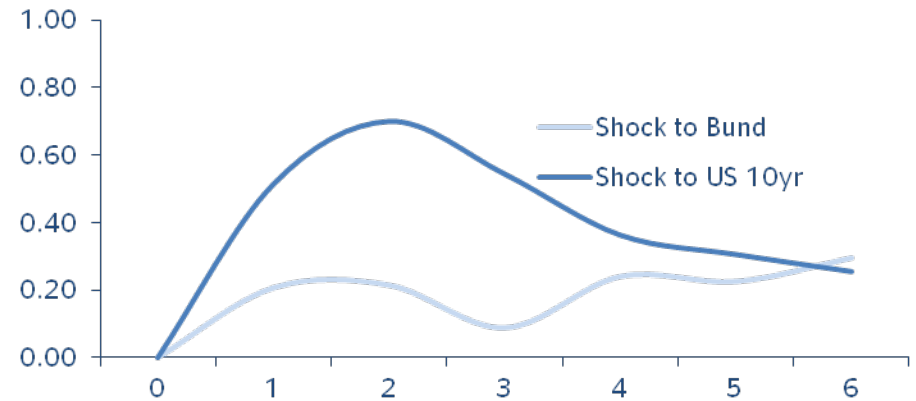
China Net Bond Inflows: Response of 40 bp reduction in US 10yr & Bund

(in % over baseline, Total Assets Under Management)
Source: BBVA Research Capital Flows DLM-FAVAR Model



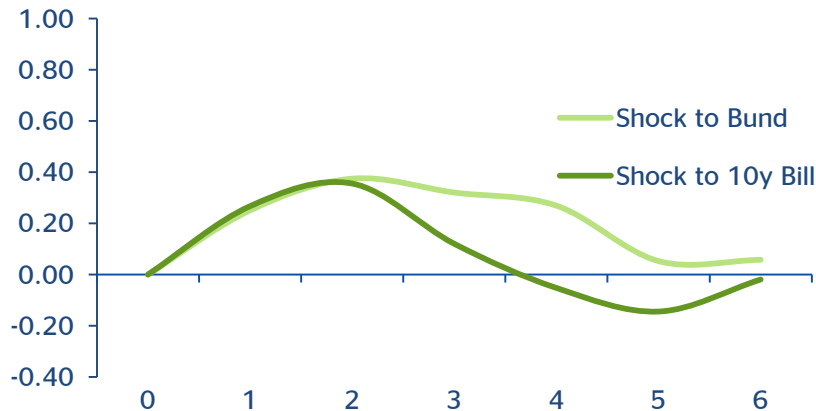
EM Net Bond Inflows: Response of 40 bp reduction in US 10yr & Bund

(in % over baseline, Total Assets Under Management)
Source: BBVA Research Capital Flows DLM-FAVAR Model



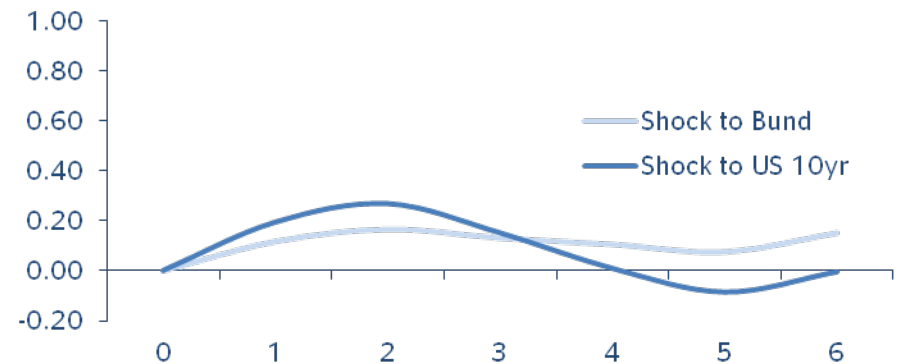
China Net Equity Inflows: Response of 40 bp reduction in US 10yr & Bund

(in % over baseline, Total Assets Under Management)
Source: BBVA Research Capital Flows DLM-FAVAR Model



EM Net Equity Inflows: Response of 40 bp reduction in US 10yr & Bund

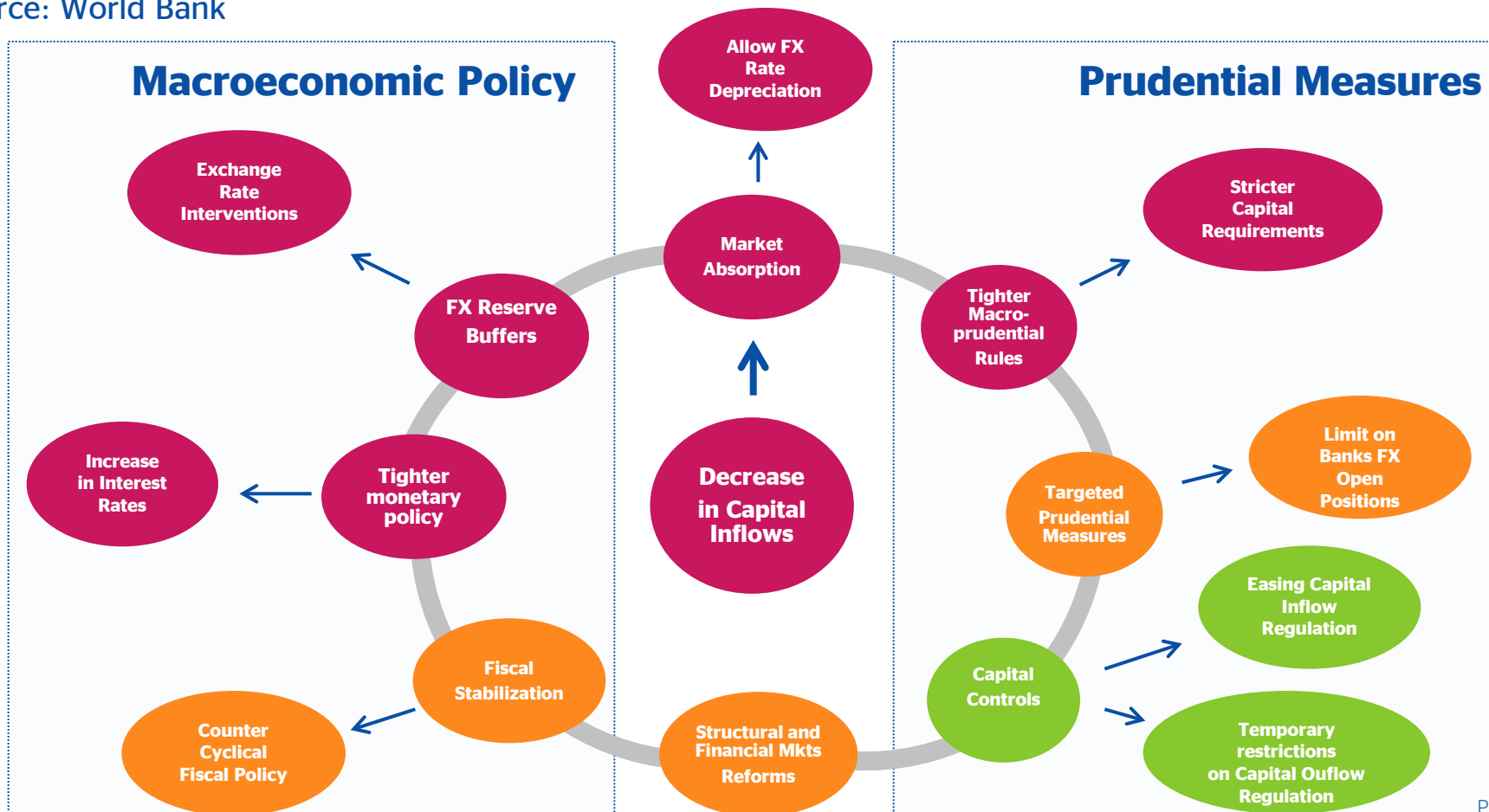
(in % over baseline, Total Assets Under Management)
Source: BBVA Research Capital Flows DLM-FAVAR Model



EMs have introduced a wealth of measures to contain capital outflows

Policy options to cope with a sudden deceleration in capital inflows

Source: World Bank



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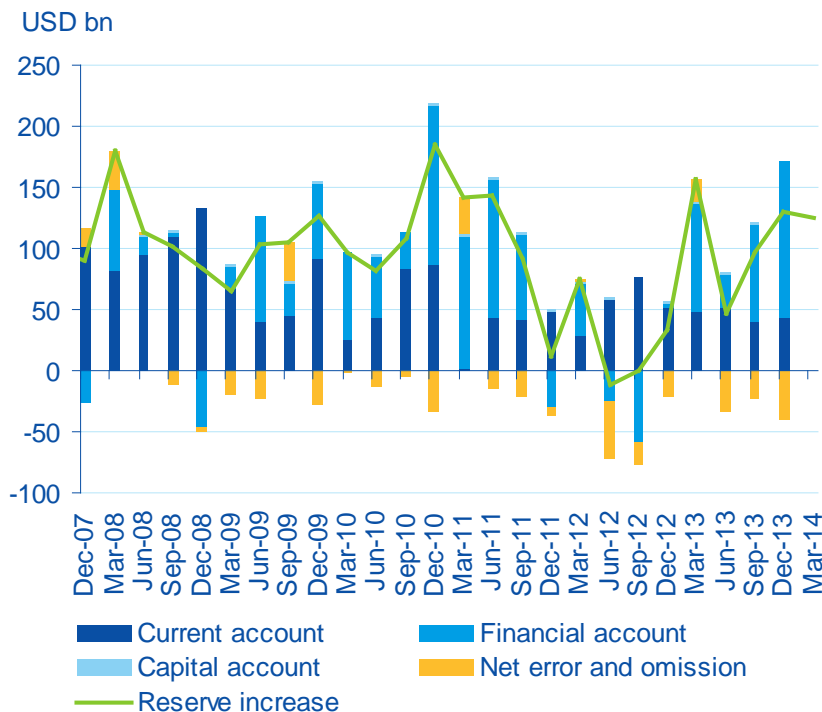
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China: BOP's situation

China: Balance of payments

Source: BBVA Research



The fluctuation of reserve increase is mainly driven by capital flows

Net error and omission reflect somewhat growing amount of outflows

Capital controls partially insulate China from external shocks bit it might change with the deepening of liberalization

How should China react?

- **Domestic factors** increasingly important at explaining China's reaction to QE tapering
 - Capital outflows very influenced by political/business uncertainty
 - Bond flows from institutional investors leading specially relevant
- The latest data points to **new capital inflows** as in the rest of EMs but situation can worsen
 - The key is no longer the speed of tapering
 - But rather earlier increase in hikes in the US
- Other things given, QE tapering, implies a more restrictive monetary policy in China as sources of liquidity are reduced.
 - PBoC can, of course, counterbalance this impact but might not be the right time (trade-off with reforms)

Thank you!

Comments welcome

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