Economic Analysis

China's Uncertainty and Risks to the U.S.

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- **A Chinese stock market shock could significantly impact the U.S. in the case of global financial contagion**
- **Trade and investment are the primary channels of impact in a severe case scenario**
- **Additional risks could emerge if China decides to sell off holdings of U.S. Treasuries**

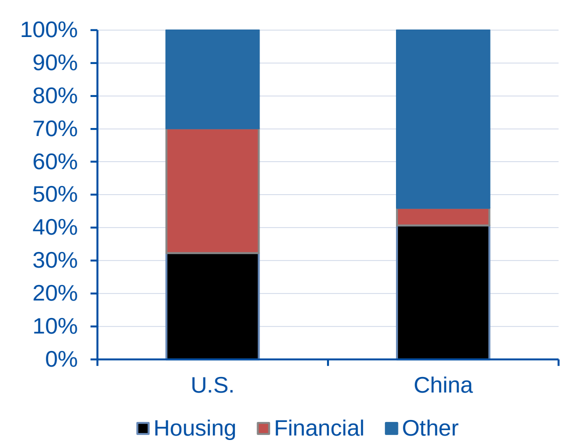
Talk of a hard landing for the Chinese economy has intensified throughout the past year, and the recent plunge in the nation's stock markets has added fuel to the fire. Last month, Chinese markets suffered a drastic decline of more than 30% before authorities stepped in to temporarily halt trading. After a few weeks of stability, equities are back in the red, with the Shanghai and Shenzhen Stock Exchange Composite Indices down another 10-11% in the past few days. Concerns are rising again as to what this means for the Chinese economy and how it will impact global financial markets.

On the surface, China's tumbling stock market appears to be headed down a dangerous path not seen since the 2008 financial crisis. However, equities in China comprise a much smaller share of total financial wealth in the country compared to other large economies. Unlike in the U.S., Chinese consumers are not much invested in the stock markets, keeping most of their savings in bank accounts or cash. Therefore the drop in equity markets should not have as big of an impact on real domestic activity as the 2008 crisis did in the U.S.

Chart 1
U.S. and Chinese Stock Market Indices

Source: BBVA Research & Haver Analytics

Chart 2
China Household Balance Sheet ($Bn eop)



Source: BBVA Research & Haver Analytics

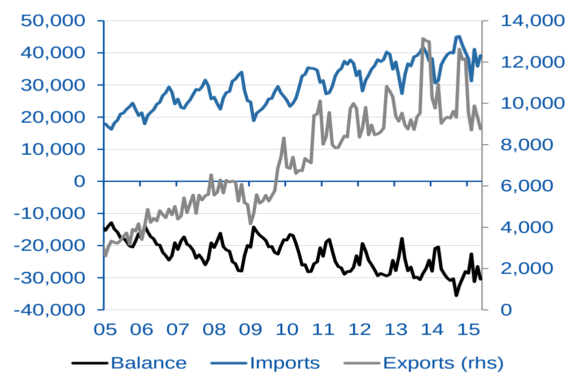
Still, the ongoing tensions in China create significant uncertainty for the global economy and pose downside risks to the U.S. Our Vector Autoregression models indicate that Chinese stock market originated shocks would carry significant risks for the U.S. equity market and economic growth only if financial contagion takes off. Impulse response estimations suggest that under globally elevated financial stress conditions, a 1% decline in the Chinese equity market will have a direct 0.72% decline in the U.S. equity market as an immediate response. Over a one-year-period a 1% drop in the Chinese stocks would translate into a 0.86% decline in the U.S. S&P 500 Index and will cost 0.08% of U.S. real GDP. The direct bilateral link between U.S. growth and China's equity market volatility is modest, and therefore, while the stock market vulnerability in the U.S. will remain, our growth outlook is primarily determined by domestic fundamentals.

Chart 3
Impact of Chinese Stock Market Decline (%)

Asia Originated Shock 1% decline in China: Dow Jones Shanghai		
Response of	1% 1st period	1% Within a year each
SP 500	0.72	0.86
US GDP	0.04	0.08

Source: BBVA Research

Chart 4
U.S. Trade with China (NSA, $Mn)

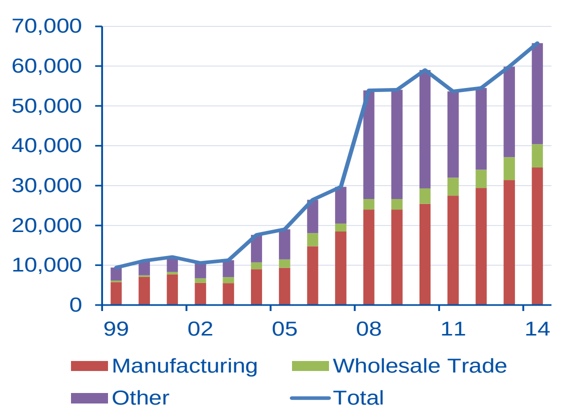


Source: BBVA Research & Haver Analytics

Other channels that connect the U.S. to China, including foreign trade and investment, may not experience an immediate shock but could suffer in the mid- to long-term. China has become the second largest U.S. trade partner, so a hard landing for the Chinese economy can pose significant risks to many U.S. industries. Although China accounts for only 7% of total U.S. exports, the U.S. imports nearly 16% of all goods and services from its Pacific ally. Furthermore, U.S. direct investment in China has increased significantly since the early 2000s, increasing risks to U.S. companies that have invested abroad. In contrast, Chinese foreign direct investment in the U.S. is small in relative and absolute terms. However, Chinese investment is important for some states such as Texas, which has attracted almost $4bn just in the energy sector. Overall, U.S. employment growth and investment could suffer if adverse shocks to foreign trade and business confidence sustain.

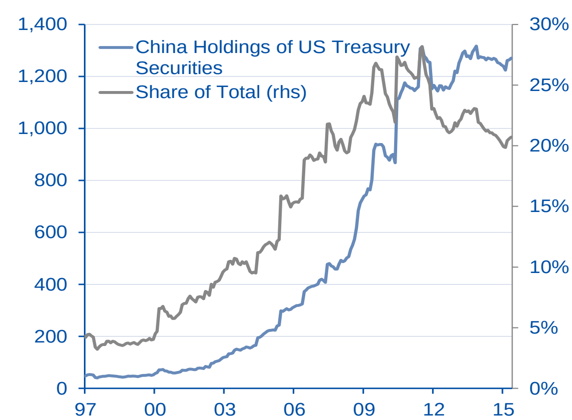
Last but not least is the fact that China has become one of the largest holders of U.S. Treasuries, with about 20% of total outstanding bonds. The risk is if/when Chinese authorities decide to sell off these holdings, as it could cause shockwaves through global financial markets, impacting not only the U.S. but many other developed and emerging economies as well.

Chart 5
U.S. Direct Investment in China ($Mn)



Source: BEA & BBVA Research

Chart 6
Chinese Holdings of U.S. Treasuries ($Bn)



Source: U.S. Treasury & BBVA Research

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