BBVA | RESEARCH

China Economic Outlook

Third quarter 2015
Asia Unit

- The global growth further moderated in the second quarter of 2015 while emerging markets are subject to intensifying growth headwinds.
- China's growth displayed some stabilizing signals in Q2. However, the recent stock market crash might impede the growth to bottom-out in Q3.
- We lowered our growth projections of 6.7% for this year and 6.2% for 2016, mainly due to the concerns about the stock market crash's spill-over effect to the real economy.
- Risks are still to the downside, the most significant of which is the stock market crash's contagious effect to the financial system and the real economy. Others concentrate the potential deflationary spiral and accelerating capital outflows.

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Closing date: August 7, 2015

1 Summary

Economic indicators are mixed in the second quarter. Despite the elevated external uncertainty surrounding the 'Grexit' and faltering international trade, growth has indeed shown some stabilizing signals, thanks to the authorities' policy easings including a flurry of cuts in the Required Reserve Ratio (RRR) and interest rates since November 2014. Q2 GDP growth grew by 7.0% in a year-on-year basis, flat with the Q1 outturn while its sequential growth rebounded to 1.7% q/q sa from 1.3% q/q sa in the previous quarter. The pickup of growth momentum was further confirmed by the bottom-out of industrial production, credit growth and, to a lesser extent, the property market.

On the other hand, a number of growth headwinds remain in place. Deflation risk is still on the rise. Headline CPI growth has been below 2% for 10 consecutive months while PPI has been in negative territory for 40 months. On top of lackluster exports, the pressure of capital outflows has intensified as the US Fed is approaching its first interest rate hike since the Global Financial Crisis (GFC).

On balance, China's economic performance in the second quarter is broadly in line with our expectation three month ago in which we anticipated growth to stabilize in the second quarter and then mildly trend up till the end of the year. Unfortunately, the ongoing recovery is likely to be disrupted by the recent financial turmoil in China's stock market. Besides dampening the confidence of private sector, the market crash is also set to weigh on household consumption due to the evaporation of their financial wealth. Moreover, it is likely to aggravate financing conditions of corporates, resulting from both the suspension of new placements and the loss of value of collateral backing bank loans. Moreover, China's domestic market rout could have spillover effects to other economies through its increasingly pivotal role in the global supply chain and financial interconnectedness.

Taking into account the market crash's adverse impact on the real economy, we lower our GDP projections to 6.7% for 2015 (versus: 7.0% y/y previously) and 6.2% for 2016 (versus: 6.6% y/y previously) respectively although a soft-landing is still achievable in our base scenario. We accordingly adjust downward our projections of inflation and exchange rate to reflect lower growth. However, we don't think that the authorities will initiate a large-scale deprecation of the RMB this year given that they are seeking to include the 'redback' in the IMF's currency basket of Special Drawing Right (SDR).

In the face of growth headwinds and the stock market crash, both fiscal and monetary policies are imperative to be more pro-growth. On the monetary policy front, after four interest rate cuts and three RRR cuts, we envisage the PBoC will implement an additional interest rate cut of 25 bps in Q3, which is likely to be accompanied by a 50-bps reduction in the RRR. Moreover, as the effectiveness of conventional monetary tools are likely to be constrained by the US interest rate hike, the PBoC will become more reliant on certain targeted policy tools to lower firms' financing costs, including direct refinancing to banks, reverse repo, lending facilities and other QE-like measures. On the fiscal front, the thrust should be to avoid sharp fiscal consolidation at the local government level. The authorities have relaxed some tightening measures imposed on local government and set out to expand the central government's fiscal deficit in the second half of the year. In addition to infrastructure investment, the authorities could consider more tax cuts for the corporate sector and increase public spending on social welfare.

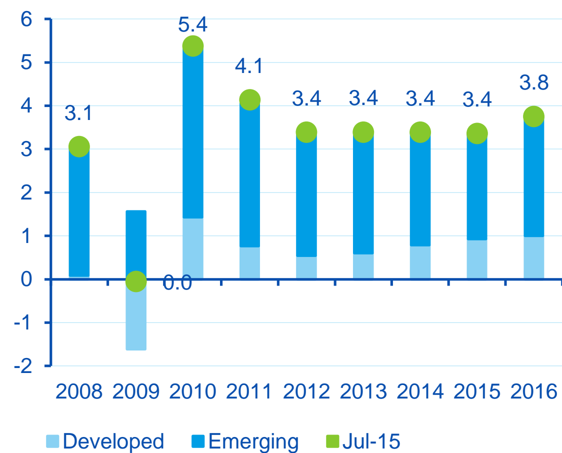
Risks to our new base scenario have become somewhat balanced with lower growth projections. Apart from a number of financial fragilities, the stock market crash could have stronger contagious effects than we expect and pose a serious threat to the financial stability. Another concern stems from the possible change of the authorities' views towards financial liberalization after the recent market crash. As far as we are concerned, the stalling reforms will bring immeasurable harm on China's growth in the long run.

2 Moderation in world growth and a marked deceleration in emerging markets

The growth figures for the major economies confirmed that world GDP decelerated in 1Q15 by showing the weakest annual rate of growth since early 2014 (2.1% compared to an average of 2.8% for the two preceding quarters) according to our estimates. The available activity indicators predict more dynamic growth in the world economy in 2Q15, on the back of the recovery in the US (after the stagnation in GDP observed in the first few months of the year), euro area strength and GDP growth in China of 7% YoY, the same reading as in the first quarter. Despite this, world GDP is likely to have grown at under 3% YoY in the first half of the year, thus justifying our downward revision of growth for 2015 as a whole (3.4%, which is 0.1pp below what we were predicting in April). Looking to 2016, the world economy could pick up pace and attain growth of 3.8%.

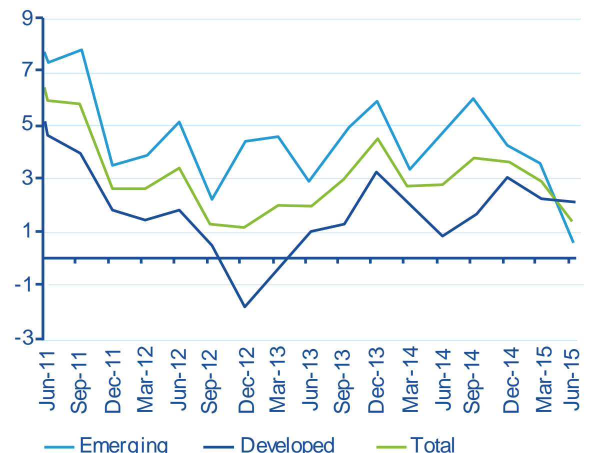
Despite the negative surprise produced by US GDP in the first quarter, the developed economies continue to share encouraging growth prospects, which will contribute to mitigate the impact on world activity and trade of the current slowdown among the key emerging economies. Specifically, while in 2015, the developed nations have the potential to grow at their fastest pace since 2010, at a shade over 2% YoY, the major emerging markets could see weaker growth again for the fifth year in succession.

Figure 2.1
World growth: annual growth (%). 2015-16 forecasts1



Source: BBVA Research

Figure 2.2
World trade (YoY change of goods export volume, %)



Source: BBVA Research and CPB

An indication of the stubbornness which has set into the deceleration of the emerging cycle is the deterioration of the readings for trade, industrial production and business confidence in some of the more notable economies since late 2014. Asia's export volume experienced the biggest quarterly correction since 2009 in the course of the first half, which was largely due to the effect of weaker demand from China on the trade flows of the other countries in the region. The industrial activity weakness in Latin America, which has been on the wane for seven consecutive quarters now, is another thermometer which tells a tale of both the impact of the lower growth in China and the loss of domestic demand pull in major economies such as Brazil. The fact that the manufacturing sector sentiment indexes in Asia and Latin America still stand at levels compatible with a contraction in production at the end of the second half does nothing to hint at any reversal

in these dynamics in the short term, above all in a context of stabilization of commodity prices at low levels (the price of Brent has come down by 10 dollars per barrel in one month to 55 dollars at the end of July). Eastern Europe's trade exposure to the euro area, and in particular Germany, accounts for the better relative performance of this region at the start of the year.

Besides the downward revision of growth forecasts for the world economy, a hallmark of the global context in the last quarter has been the manifestation of some of the risk events that we singled out three months ago and, if they take a turn for the worse, this could bring the global economic recovery to a halt. The first of these involves the bout of financial instability in China. This was brought about by the sharp correction of its stock market, within a situation of trend deceleration in growth, which has drawn on substantial borrowing, and a process of financial liberalisation still underway. The second, which is equally significant, is the Greek crisis, and the constrains to reach an agreement that ensures that the country will face its financial commitments in the short term, as well as the sustainability of its debt via reforms to enhance the economy's capacity to grow in the long term.

The combination of these two risk events, together with the approach of the Fed's rate hike, has heightened financial disruption the world over, particularly in the form of greater volatility in stock and currency markets, with a heavier impact on the euro area and Asia. The upturn in the BBVA financial tensions index has been significant, both among the block of developed countries and in their emerging counterpart, since the end of 2014. In this regard, the maintenance of loose monetary policies, above all in the wake of the implementation of the ECB's public debt purchase programme, is proving decisive. Even so, the risk that we might see a further outbreak of financial volatility when the US rate hike cycle takes place remains high.

Looking in more detail at the key areas, note the sharp slowdown in the US economy, with essentially stagnation of GDP in the first quarter, while the progress made in 2Q15 was only modest judging by the available indicator readings for activity and confidence. The worse than expected first half on balance warrants a downward revision for growth for 2015 as a whole, which could amount to 2.5%, or some 0.4pp below the level we forecast in April. The uncertainty over how the economic cycle will perform in the coming quarters has now been heightened bearing in mind the impact of the persistent dollar appreciation on exports, the weakness of private investment and the deterioration in the global situation. Even so, US GDP could grow by 2.8% in 2016.

In addition to consolidating the economic recovery, the euro area faces major challenges in the medium term. Without a doubt the most significant of these is to try and dispel any scepticism about the irreversibility of the monetary union project. The financial firewalls, progress in banking union and the reforms undertaken in the area's various economies, as well as the reinforcement of the economic cycle, have substantially reduced the financial contagion from the Greek crisis compared to 2010 and 2012. Even so, in the absence of greater progress towards unifying banking and capital markets which might allow a reduction in financial fragmentation, plans that demonstrate the will to move towards greater fiscal integration, and without any rethinking of potential bailout programmes, the risk of disruptive scenarios emerging in the euro area as a whole is high. The discrepancies observed in the negotiations between the Greek government and the European authorities, and between the latter and other official organisations such as the IMF in relation, for example, to the need to deal with the issue of debt restructuring, are evidence of the need to define a framework for handling financial assistance for countries with debt sustainability problems that goes beyond fiscal consolidation.

3 Green shoots appeared in the second quarter

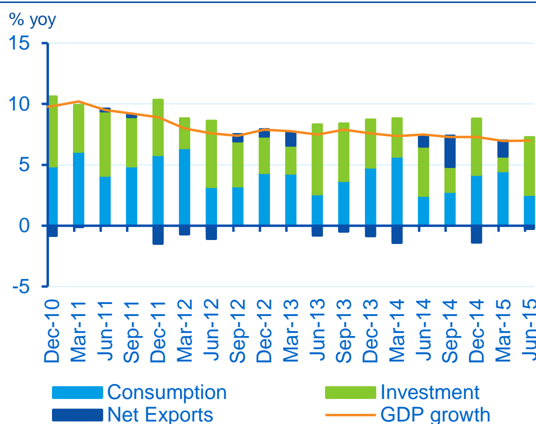
China's Q2 GDP growth came out at 7.0% y/y, flat with the Q1 outturn while above market expectations (BBVA: 6.8% y/y versus Consensus: 6.8% y/y). In sequential terms, Q2 GDP expanded at a pace of 1.7% q/q sa, increasing from 1.3% q/q sa of Q1 2015. (Figure 3.1) Green shoots of economic recovery are mainly due to a flurry of easing measures through the second quarter, including two back-to-back interest rate cuts in May and June, a selective cut in banks' RRRs, and some QE-like measures such as the debt swap program earmarked for local governments. The transmission from the easing monetary measures to the inter-bank market also became more smoothly going as the sharp appreciation of the USD has slowed in Q2. Overall, the authorities' persistent easing efforts not only dispelled policy uncertainties at the beginning of this year but also helped to lower financing costs for the corporate sector.

However, the stock market rout occurred in June-July has disrupted the ongoing growth recovery. Although a full-blown financial crisis is averted thanks to the authorities' interventions, its adverse impact on the real economy is expected to last till next year. (We will elaborate on this point in Section 5)

Both manufacturing activities and investment modestly picked up at end-Q2…

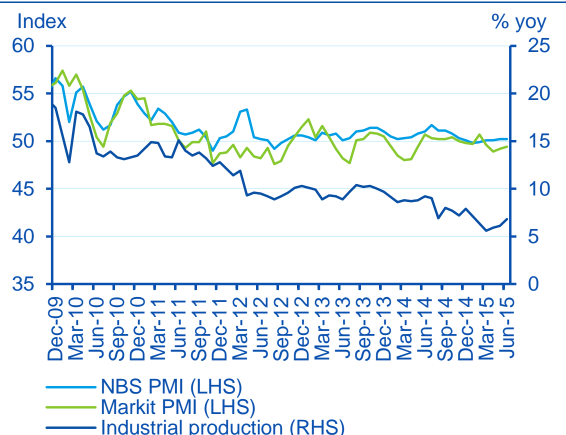
The growth of industrial production accelerated to 6.8% y/y in June, above market expectations of 6.0% and the last month's reading 6.1%. (Figure 3.2) On the demand side, retail sales growth in June rose to 10.6% y/y (consensus 10.0% y/y) from 10.1% y/y in the previous month. (Figure 3.3) Investment also stabilized as its YTD growth came at 11.4% in June (consensus: 11.2% y/y), flat with that of May. By categories, infrastructure investment held up due to the authorities' easing measures while the real estate investment and manufacturing investment remained anemic. (Figure 3.4)

Figure 3.1
Growth slightly picked up in Q2



Source: NBS, CEIC and BBVA Research

Figure 3.2
Manufacturing activities rebounded modestly

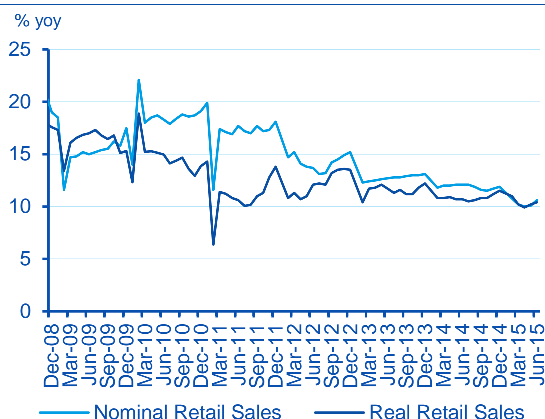


Source: CEIC and BBVA Research

Notwithstanding some green shoots perceived in activity indicators, the leading PMIs don't bode well for the sustainability of the ongoing economic recovery. In particular, Caixin China PMI slumped to 47.8 in

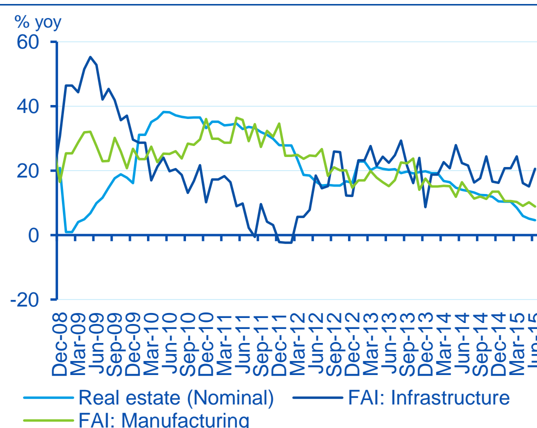
July from its June reading of 49.4, hitting its 15-month low (Market Consensus: 49.7) and pointing to a further dip of manufacturing activities. (Figure 3.2) In the meantime, the official PMI also fell to the watershed level of 50.0 (consensus: 50.1) in July from 50.2 in the previous month. We reckon that the pickup of growth momentum has been disrupted by the recent stock market crash.

Figure 3.3
Retail sales still held up



Source: NBS, CEIC and BBVA Research

Figure 3.4
Real estate investment continued to trend down



Source: NBS, Wind and BBVA Research

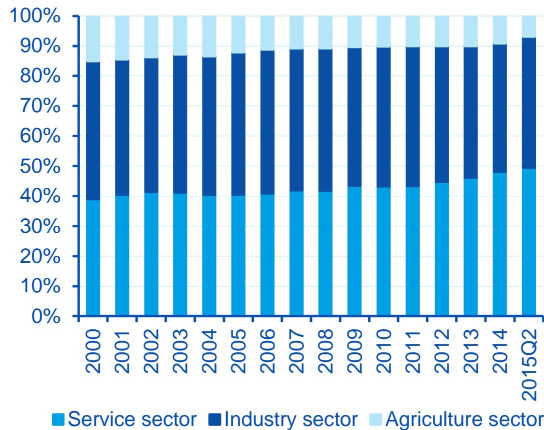
The financial sector remained as an important driver of growth in Q2

By sectors, the tertiary industry continued to outperform, registering a growth rate of 8.4% y/y in 1H 2015 (versus 3.5% y/y and 6.1% y/y for the primary and secondary industries respectively). In particular, the growth of the financial sector, which is a sub-sector of the tertiary industry, climbed up to 17.4% y/y in 2H 2015 from 15.6% y/y in Q1, remaining as the biggest growth driver to GDP in the service sector. (Figure 3.5 and 3.6) Our back-of-the-envelope calculation shows that Q2 GDP growth could slow to 6.5% (instead of 7.0% y/y as reported) if the financial sector only grows at an average level in the past couple of years. It however adds our concerns about the growth outlook in the second half of the year because the exceptional growth of the financial sector is largely associated with the booming stock market which unfortunately has reversed course since mid-June. (Figure 3.7)

The labor market was still healthy

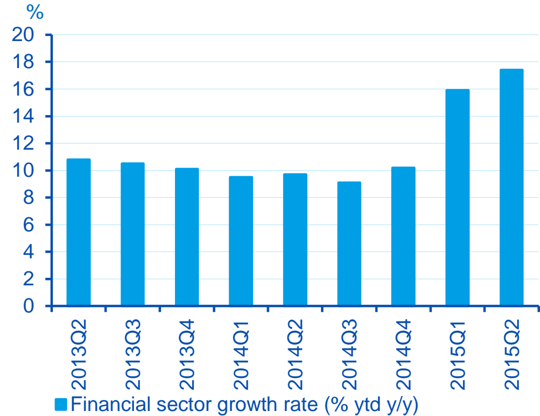
The labor market was in good shape in Q2. In the first half of 2015, the newly increasing employment reached 7.18 million, fulfilled 71.8% of the annual target. The urban registration unemployment rate even edged down to 4.04% at end-Q2, maintaining at a comparatively low level. In the meantime, the ratio of demand to supply in the labor market ticked up from the last quarter, reflecting the tightness of the labor market. (Figure 3.8) The robust labor market was mainly due to the continuous development of the service sector. However, it is worth noting that unemployment rate is generally a lag indicator, which is all the more so in China due to its data quality problem.

Figure 3.5
The service sector took the lead in Q2 growth recovery



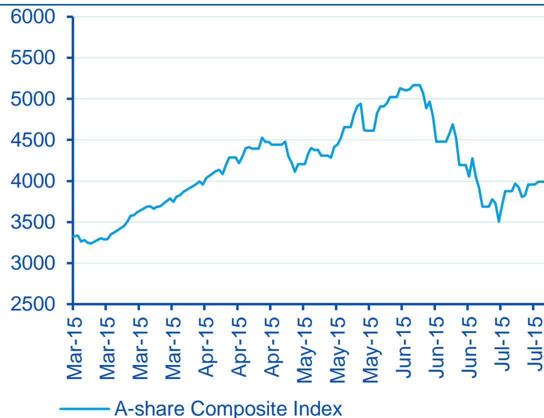
Source: CEIC and BBVA Research

Figure 3.6
The financial sector continued its exceptional performance in Q2



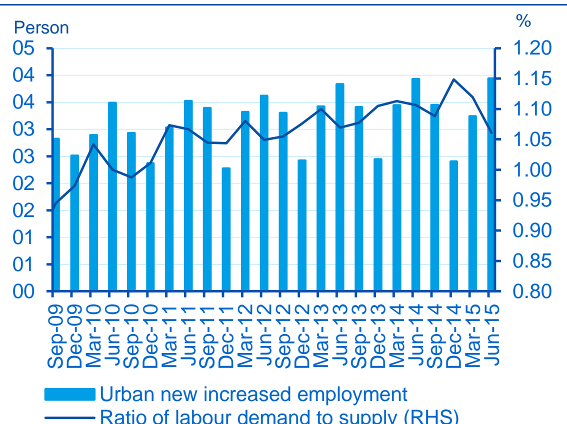
Source: CEIC and BBVA Research

Figure 3.7
A stock market rout happened in mid-June



Source: CEIC and BBVA Research

Figure 3.8
The labor market was in a good shape



Source: CEIC and BBVA Research

Deflation risk hasn't abated yet

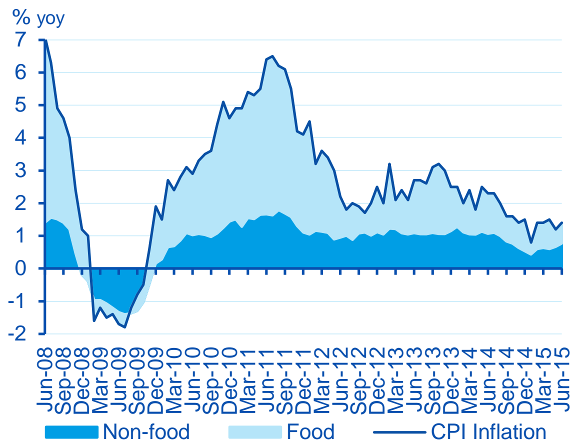
June headline CPI came out at 1.4% y/y, slightly higher than both the market consensus of 1.3% and the previous reading of 1.2%. The low inflation outturn is broad-based: food price generally decelerated except that pork price increased significantly due to its production cycle. Meanwhile the growth of housing rentals slowed in parallel to the subdued property market. (Figure 3.9)

The PPI growth rate dropped further to -4.8% y/y (consensus: -4.6%y/y) in June from -4.6% y/y in the previous month. The period of PPI staying in negative territory lasted for 40 consecutive months by June. The continuously deflation in the PPI is mainly due to the domestic price decline in several upstream industries including oil refinery, iron & steel, non-ferrous metals, coal, etc. (Figure 3.10)

On top of the pass-through from the PPI, several factors could also aggravate the deflation risk in China, including the potential burst of property bubble, the over-capacity in certain industries, the high debt level of the corporate sector and the ageing population. The recent market crash could also add further downward

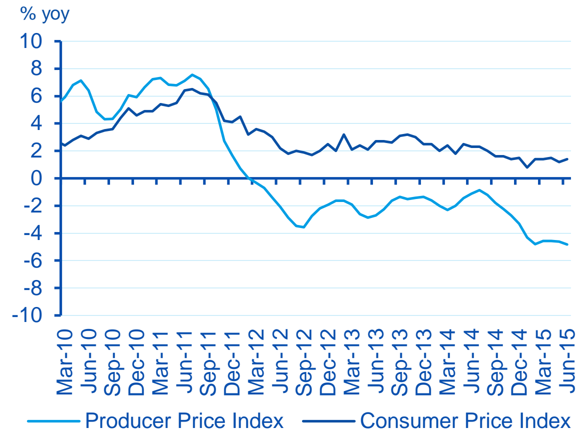
pressure on price index if households are to reduce their consumption due to the negative wealth effect or firms are to hold back their investment on deteriorating financial conditions.

Figure 3.9
Below-2% CPI lasted for 10 consecutive months...



Source: CEIC and BBVA Research

Figure 3.10
… while PPI inflation was in the negative territory



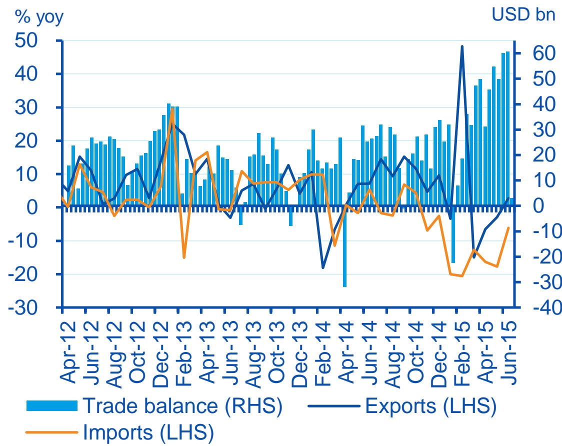
Source: CEIC and BBVA Research

Exports slightly picked up but external uncertainty still weighed on its outlook

June trade data slightly picked up, as both exports and imports beat both the previous readings and market expectations. In particular, June exports registered a year-on-year increase of 2.8% (consensus: 1.0% y/y and prior: -2.5%) while imports contracted by -6.1% y/y (consensus: -15.5% y/y and the prior: -17.6%). For 1H 2015 as a whole, exports increased by 0.9% y/y while imports declined by -15.5% y/y; altogether, the trade surplus expanded by 150% y/y. (Figure 3.11)

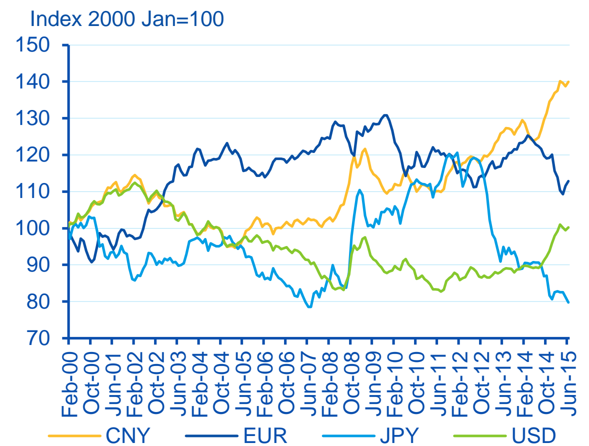
On top of the intrepid economic recovery in advanced countries, especially the previous “Grexit” uncertainties in Europe, the lackluster performance of the export sector also stemmed from the RMB’s relative strength against other currencies (except for the USD) (Figure 3.12). To further stimulate the exports in order to support growth, the State Council promulgated a series of new policies. The most important one is to expand the RMB floating band, after three expansions since the 2005 exchange rate reform. Other policies include further facilitating the cross-border RMB settlements, promoting more financial products to help enterprises avoid the exchange rate risks, expanding the export credit insurance, etc.

Figure 3.11
Both exports and imports are picking up slightly in recent months



Source: CEIC and BBVA Research

Figure 3.12
The State Council tries to expand RMB trading band (i.e. to depreciate RMB) to stimulate exports



Source: CEIC and BBVA Research

Capital outflows accelerated but is still manageable

Based on the June outturns, foreign reserves decreased to 3690.0 billion RMB from the previous 3730.0 billion RMB (consensus: 3702.5 billion RMB). (Figure 3.13) It has added people's concerns about the increasing risk of capital outflows.

It is true that capital outflows are accelerating to leave China in the face of US Fed's lift-up of interest rate. However, such a trend is indeed associated with the corporate sector's ongoing adjustment of currency mismatch in their balance sheets. China's corporate sector has amassed a vast amount of debt denominated in the USD over the past several years. The resultant currency mismatch (USD denominated liability combined with RMB denominated income) can not only help those firms to lower their financing costs (stemming from the Fed's ultra-loose monetary policy) but also bring additional benefits if the RMB keeps appreciating against the USD. Now things changed with the strengthening of USD appreciation expectation. To avoid unexpected losses incurred by the RMB depreciation against the USD, those Chinese firms scrambled to acquire USD to pay off their debt in a bid to correct the previous currency mismatch. As a result, the BIS statistics show that foreign banks' claims on China decreased by 128 billion USD during Q4 2014 to Q1 2015.

On balance, the risk of capital outflows is thus far manageable given that it is mainly due to corporates' adjustment of the currency mismatch in their balance sheets. However, the recent stock market crash could exacerbate capital outflows and threaten the financial stability, which we are to discuss in Section 5.

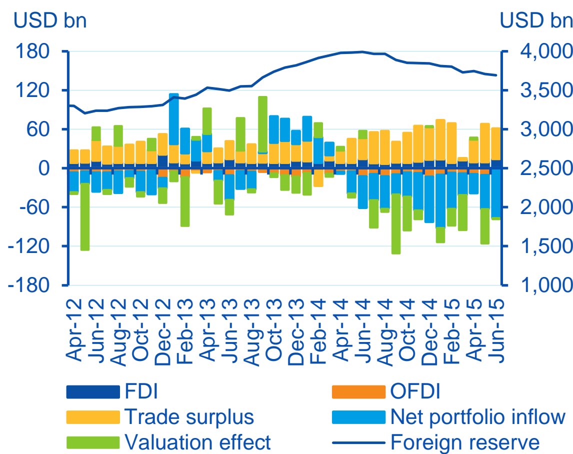
Credit picked up modestly due to monetary easing measures

The sluggish growth and the stock market crash have prompted the authorities to beef up their efforts of policy easing. The People's Bank of China (PBoC) have been easing monetary policy since November 2014. In Q2, the PBoC implemented two back-to-back interest rate cuts in May and June, at the same time, a targeted cut in the Reserve Requirement Ratio (RRR) was deployed to provide more liquidity to banks focusing on SMEs businesses and the agriculture sector. As we anticipated in last quarter's *China Economic Outlook*, some QE-like measures have been implemented in the second quarter. First, a debt swap program was piloted to facilitate local government issued municipal bond to replace their existing bank loan. Then the PBoC allowed banks to use the local government bonds as collaterals to obtain long-

term funds from the central bank. Now the program's size for this year is RMB 2 trillion but is reported to increase to RMB 3 trillion or even more. Second, the PBoC and the Ministry of Finance (MOF) have injected USD 155 bn to three "policy banks" (public banks) from foreign reserves, enabling them to boost their balance sheets in support of domestic growth and facilitate China's national strategy of increasing overseas investment. Policy easings also led to a decline of interbank interest rate. (Figure 3.14)

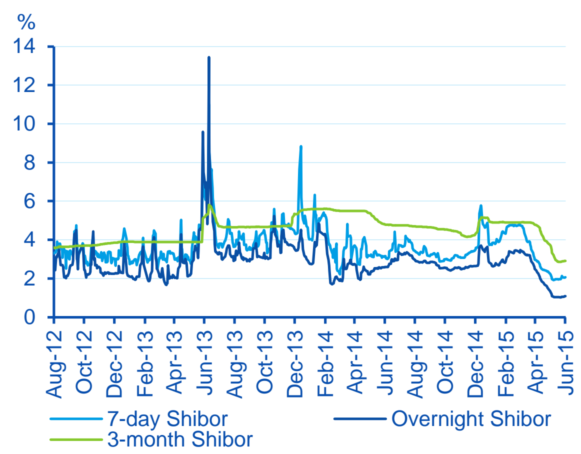
Due to the authorities' aggressive easing monetary policies, credit growth in June was higher-than-expected: new bank loans accelerated to RMB 1279.1 billion from RMB 900.8 billion in May (consensus:1050.0 billion RMB). Total social financing also increased to RMB 1860.0 billion from RMB 1236.2 billion in May. (Figure 3.15) Moreover, M2 growth accelerated to 11.8% y/y in June (which was below the official target of 12%) from 10.8 % y/y in the previous month (consensus: 11.0%). (Figure 3.16)

Figure 3.13
Capital outflows led to diminished FX reserves



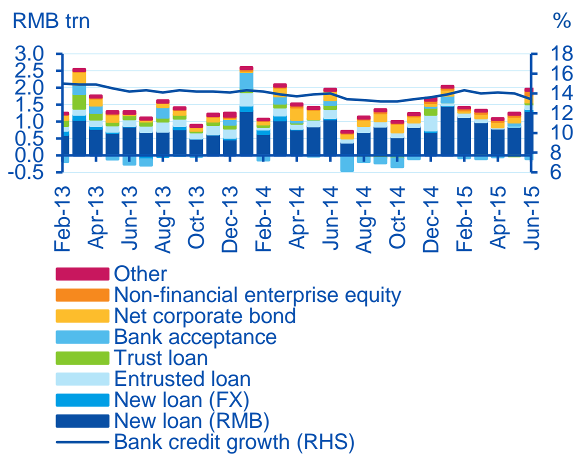
Source: CEIC and BBVA Research

Figure 3.14
The interbank rate slowed down in June



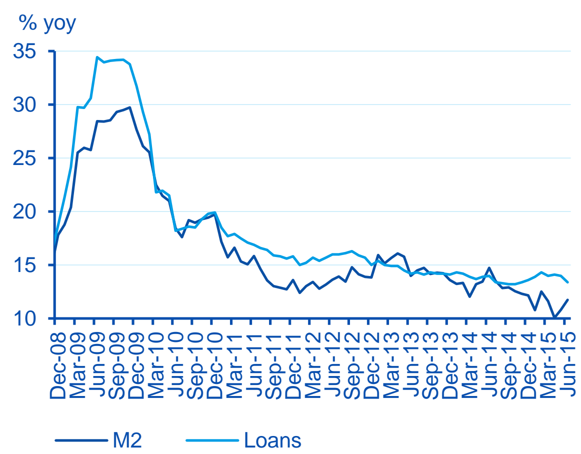
Source: CEIC and BBVA Research

Figure 3.15
Total Social Financing picked up in Q2…



Source: CEIC and BBVA Research

Figure 3.16
… along with M2 and bank loans

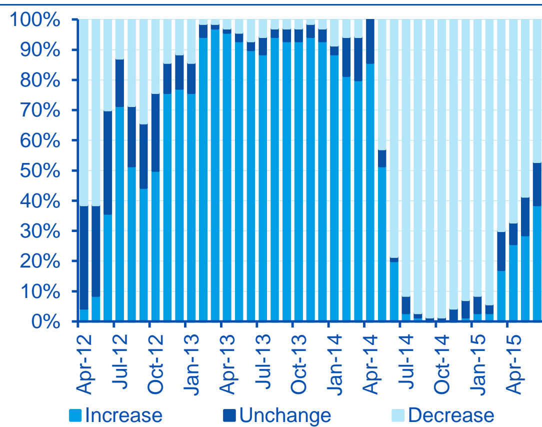


Source: CEIC and BBVA Research

Property price started to pick up but investment is still stagnant due to the large undigested inventory

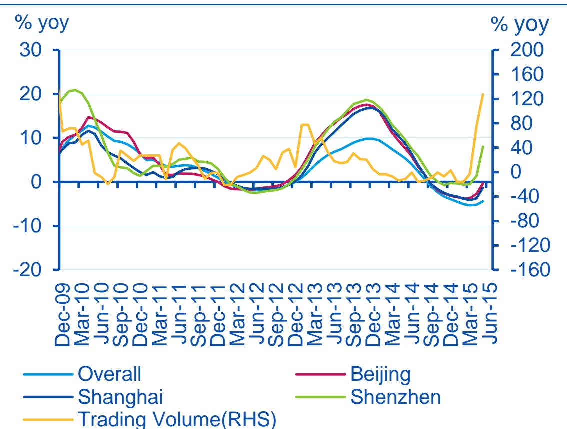
The property market has showed some signs of improvement in Q2. As revealed by the NBS, 27 out of seventy cities reported a month-on-month increase in June, compared with 20 cities reported in the previous month. (Figure 3.17) However, the price-increasing all concentrated on the tire-one cities. Moreover, the property trading volume significantly picked up in Q2, compared to a negative reading in the last quarter (Figure 3.18). We anticipate that after the property inventory gradually sold out, the investment will finally pick up as well, then, housing price and trading volume growth will become more sustainable in the mid-run.

Figure 3.17
Some positive signals of property market appeared



Source: NBS and BBVA Research

Figure 3.18
Trading volume and housing price has bottomed out in Q2



Source: NBS, CEIC and BBVA Research

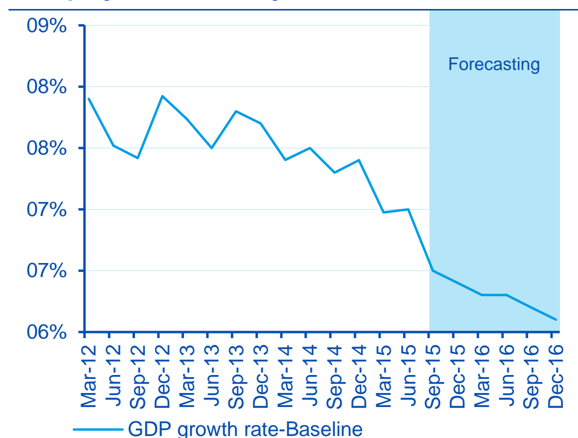
4 Growth outlook has become dimmer due to the recent stock market crash

Despite the growth stabilization in Q2, the recent stock market crash, along with a number of headwinds, will impede the growth bottom-out in the second half of 2015. Such a dim outlook has been confirmed by recent weak outturns of leading indicators like PMIs. The authorities are anticipated to implement more pro-growth measures to sustain the economy and avoid a hard-landing although the chance of meeting their preset growth target of 7.0% this year has largely diminished.

We lower our 2015 and 2016's growth projection to 6.7% and 6.2% respectively, down from 7.0% and 6.6% previously (Figure 4.1). In terms of GDP components, consumption is expected to continue its outperformance over the investment and net exports, benefiting from the on-going structural reform.

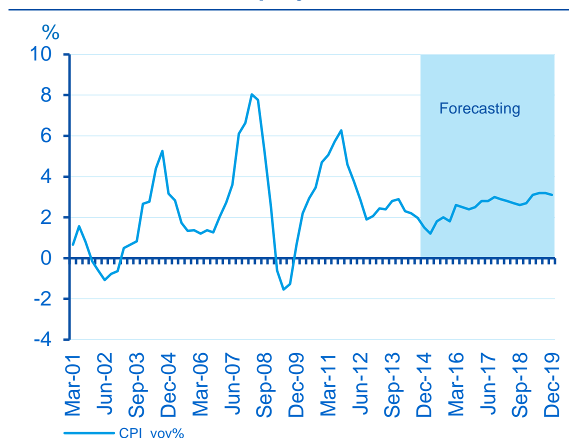
On inflation, we further lower our annual average projection of 2015 to 1.7% and 2016 inflation to 2.0%, reflecting the increasing deflation risk from falling commodity prices, weak investment demand and the persistent overcapacity in a number of domestic industries. On the other hand, a healthy labor market and solid growth of household income could lessen downward pressure on consumer prices.

Figure 4.1
GDP projections are adjusted downward…



Source: NBS, CEIC and BBVA Research estimates

Figure 4.2
…as well as inflation projections



Source: NBS, CEIC and BBVA Research estimates

The authorities need to beef up easing efforts

In the face of growth headwinds and the stock market crash, both fiscal and monetary policies are imperative to be more pro-growth. On the monetary policy front, after four interest rate cuts and three RRR cuts, we envisage the PBoC will implement an additional interest rate cut of 25 bps in Q3, which is likely to be accompanied by a 50-bps reduction in the RRR. Moreover, as the effectiveness of interest rate cuts is likely to be constrained by the US interest rate hike, the PBoC will become more reliant on RRR cuts and other unconventional policy tools to lower financing costs for firms, including selective RRR cuts, direct refinancing to banks, reverse repo, and short or medium term lending facilities.

On the fiscal front, the thrust should be to avoid sharp fiscal consolidation at the local government level. The authorities have indeed started to relax some tightening measures imposed on local government borrowing as well as to expand the central government's fiscal deficit in the second half of the year. In addition to

infrastructure investment, the authorities could consider more tax cuts for the corporate sector and increase public spending on social welfare.

Interestingly, the line between fiscal and monetary policies has blurred in that the authorities have increasingly leveraged the balance sheets of three “policy banks” (namely, China Development Bank, China Agricultural Development Bank and China Export-Import Bank) to extend new credit and spur investment demand. After the recent capital injection mentioned previously, these “policy banks” are gearing up to raise more funds from the market and then invest proceeds in infrastructure investment projects with the central government’s subsidy. To a large extent, these “policy banks” seemingly take place of local governments to become the stakeholders in infrastructure projects. Such an approach tends to increase the contingent debt level of the central government rather than the real debt level, making the balance sheets of the central and local governments look better. Nevertheless, in practice it is difficult for “policy banks” to effectively monitor and manage investment projects relative to local governments, which could aggravate the risk of rising NPLs. That being said, the authorities need to walk a fine line between spurring domestic demand and curbing the overall debt level of the economy.

The RMB exchange rate is expected to mildly depreciate in 2H 2015

Although the authorities have vowed to increase the flexibility of the RMB exchange rate, we believe that the recent market crash will make them reluctant to allow a sharp depreciation over the concerns of triggering the vicious circle of currency depreciation and capital flows. Moreover, the authorities are striving to persuade the IMF to include the RMB in the currency basket of Special Drawing Rights (SDR). Given that the final decision of the IMF is to be announced this November, we anticipate that the RMB exchange rate will be relatively stable between now and then. Therefore, we slightly downward adjusted our baseline projection that the CNY/USD exchange rate will slightly depreciate in the second half of the year and stabilize around 6.27 at the end-2015. (Table 4.1) Regarding the medium-term projection, we broadly agree with the IMF’s assessment that the current RMB exchange rate is “fairly valued” and keep our end-of-year projection at 6.15 for 2016. It also indicates the increasing volatility of the RMB exchange rate accompanied with the prospective widening of the daily trading band.

Table 4.1
Baseline Scenario: Forecasting

	2012	2013	2014	2015 (F)	2016 (F)
GDP (%, y/y)	7.7	7.7	7.4	6.7	6.2
Inflation (average, %)	2.6	2.6	2.0	1.7	2.0
Fiscal balance (% of GDP)	-2.1	-1.9	-1.8	-2.5	-2.5
Current account (% of GDP)	2.3	2.0	2.5	2.8	2.8
Policy rate (%)	6.00	6.00	5.60	4.60	4.60
Exchange rate (CNY/USD)	6.23	6.05	6.21	6.27	6.15

Source: BBVA Research

5 China's economy in the limelight: size, financial interconnections and potential contagion channels abroad

All eyes have been centred on the swelling and bursting of China's stock market bubble, given its potential impact on the domestic economic cycle, as well as global financial stability and economic growth. There are basically three channels for contagion abroad, and all of them are significantly or increasingly far-reaching. The first of these is deterioration in local private-sector confidence, which causes the private sector to hold back on its investment decisions and amplifies the slowdown in activity, thereby spreading to the rest of the world via trade and foreign investment. The second is a widespread tightening of financing conditions among the emerging markets, which is exacerbated by the effect of lower Chinese demand on commodity prices and the imminent Fed rate hike. The third, though not the least significant, relates to how the Chinese economy is financially interconnected elsewhere, both by virtue of its status as a net creditor of the rest of the world and its positions in terms of purely financial capital flows[1].

It may be concluded from inspection of China's relative critical mass within global economic and financial channels that the biggest risk to world economic growth lies in any sharp contraction of its activity levels, which moreover could translate into increased risk aversion in the EM block and affect those economies which have the most trade exposure, the greatest dependence on the commodity cycle and/or the largest external imbalances differently. A scaling down of decisions by China to invest in the rest of the world could also give rise to deterioration in financing conditions, given that it is the world's largest net creditor and the biggest foreign holder of US sovereign bonds.

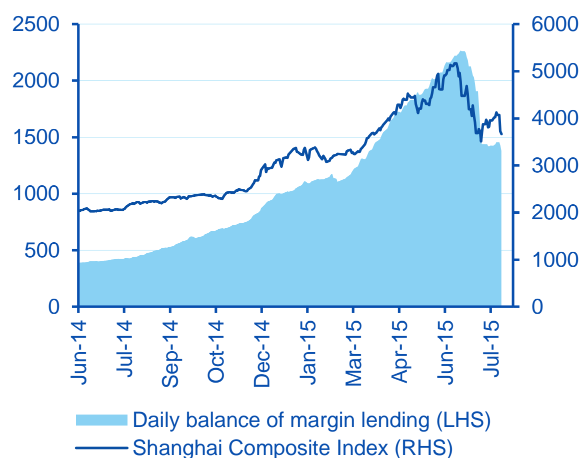
As for financial exposure to China, this is basically within the banking sector, which has played a key role in increasing the country's external debt in the last decade. Thus, and taking into account financial centrality metrics developed by BBVA Research, if the shock were to affect the local banking sector, the financial channel could take on global significance: the interconnectedness of China's banking sector with the world financial system comfortably outstrips the average for the EMs and is even above the average for developed markets, although considerably far behind countries such as the US.

Factors behind the Chinese stock market correction

Every market crash starts from its preceding run-up. China's case is no exception. Prior to the sell-off of mid-June, China's Shanghai Composite shot up from 2,181 points to 5,166 points in less than one year. For many small stocks, their magnitude of price increase outperformed the stock index substantially.

1: China's capital account is not completely closed, although there are still many restrictions in place. Through some programmes (QFII and RQFII), foreign investors can invest in China's domestic bond and stock markets. In the meantime, domestic investors can invest abroad through the QDII programme. The Shanghai-Hong Kong stock exchanges link programme, which was implemented last year, provided another channel for two-way cross-border investment between Hong Kong and China. Moreover, after several years of efforts, China has successfully established an offshore RMB market in Hong Kong and other financial centres. We know the offshore RMB deposit amounts to above RMB1trn (or USD160bn). There are other offshore RMB markets such as Dim Sum bond market and the RMB derivatives market.

Figure 5.1
Margin lending fuelled China's stock market boom



Source: BBVA Research

Table 5.1
Measures to stabilise the Chinese stock exchange

	Regulator	Date	Measure
1	PBoC	June 24	PBoC scraps loan to deposit ratio cap
2	PBoC	June 27	Rate cut by 25bp with a targeted RRR cut of 50bp
3	CSRC	July 5	IPOs suspended
4	PBoC	July 5	Establishment of USD19bn Financial Stabilization Fund by 21 brokers
5	PBoC	July 5	Liquidity support for China Securities Finance Corporate for the latter to buy shares in the market directly
6	CSRC	July 7	QFII told not to take new positions in future markets
7	CFFEX	July 8	Raise margin requirements for sell orders on CSI 500 index futures

Source: BBVA Research

A confluence of measures led the market to rally in such a short period: first, the government's support for HI-Tech listing firms have greatly lifted investors' expectations; second, in the face of growth slowdown the People's Bank of China (PBoC) have implemented a series of easing measures since November including interest rates and Required Reserve Ratio (RRR) cuts; third, the government, for the purpose of reducing corporates' reliance on debt financing, inappropriately favoured retail investors into the equity market. More importantly, investors increasingly used margin loans from banks, security firms, trust companies and other shadow banking institutions to maximise their investment returns.

The market rally ended in mid-June when the trends in some of above-mentioned factors reversed. As the market rocketed up, the valuation of many stocks had gone far beyond levels justified by fundamentals. With some positive signs of growth stabilisation emerging in the second quarter, investors grew suspicious of the continuation of the PBoC's easing stance. Even worse is that the authorities, in the wake of investors' fast-rising leverage, started to tighten margin loans through the shadow banking sector.

When a large number of investors attempted to reduce their positions at the same time it soon translated into a text-book sell-off in the equity market. The initial correction of share prices caused by selling orders alerted other investors, in particular those who borrowed margin loans. To manage their risk exposure to the market, many leveraged investors opted to sell part of their shares, which magnified the supply in a short time and put more downward pressure on share prices. The market thus entered a vicious circle: the more leveraged investors wanted to sell their shares, the further share prices fell, which encouraged more leveraged investors to sell.

The authorities' rescue package is controversial

To stop the sell-off in the market the government has unleashed a set of bailout measures to stabilise it, including suspending IPOs, raising short-selling costs of stock index futures, directing insurance funds towards the stock market, etc. (Figure 5.1). And more importantly, the authorities instructed banks to lend money to the China Securities Finance Corporate so that the latter can prop up share prices through a buying spree in the market.

Although these measures have stabilised the market for a while, they failed to address a number of factors that spawned the sell-off, some of which have even been exacerbated by the authorities' actions. For

example, the excessive use of margin lending has been widely blamed as one of the culprits for the run-up of share prices and the ensuing market plummet. As of 22 July, the official statistics of margin lending stood at RMB1.44trn, which is down from its peak of RMB2.27trn on 18 June but is still way above its daily average level of RMB0.52trn last year. These figures do not include margin lending through shadow banks.

Even the government's interventions themselves bear significant risks. The bailout measures functioned at the expense of market-based rules. This has largely dampened investors' confidence in China's stock market and driven away "smart money" institutional investors. As a consequence, market trading is expected to be increasingly dominated by retail investors and even more susceptible to their herd behaviour.

The recent sell-off could lead both foreign and domestic investors to rebalance their portfolio and reduce their positions in China's stock market. Additionally, if the market crash leads to large-scale capital flight, China's government might need to tap the foreign reserves to guard against the free-fall of its currency. That means the policy-makers could need to unwind part of US treasury bonds in their hands in the international market, which could have an impact on global financial market.

Adverse impact of the market crash on the outlook for China's economic growth

Looking ahead, we expect the stock market crash to have an adverse impact on the real economy. The channels from the financial market to the real economy include: i) the diminished brokerage services as part of total GDP; ii) firms' constrained financing channels due to the suspension of IPOs; iii) shrinking household wealth[2]; and iv) the impact of the deterioration in confidence of foreign capital on China's economy and financial system. We have therefore lowered our growth projection for FY15 to 6.7% and to 6.2% for FY16.

Worse is that the market crash has avoidably added uncertainty to the ongoing liberalisation of the capital account. The authorities could become more conservative after such a hard hit. The flaws in China's regulatory framework which were exposed by the market crash might make policymakers reluctant to open the domestic market to foreign investors. On the contrary, the authorities should not halt the opening of its capital account. By inviting more foreign investors, in particular institutional investors, into the domestic market, the authorities could balance the dominance of retail investors and make the market less susceptible to herd behaviour. Moreover, opening the capital account could also help domestic households to diversify their investments. The lack of suitable alternative investment choices for retail investors contributed to the overheating in both property and equity markets.

China's economy: heightened global importance including financial interconnectedness

Analysis of China's relative significance in global economic and financial channels are key to gauging the systemic nature of any bout of financial instability in the country, regardless of the fact that this might also have an impact on its growth dynamics.

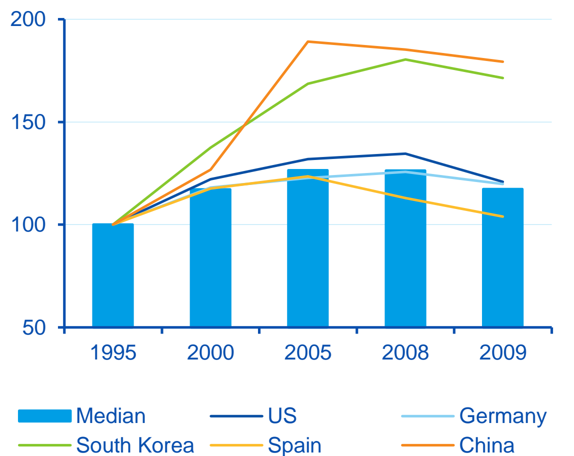
China's participation in global chains of goods and services (interconnectedness in real economic flows) has been expanding at a particularly brisk rate since the mid-1990s. The most direct way to measure a country's degree of interconnectedness within overall real economic flows (share in global value chains-GVC-) is to find the sum of the imports of goods and services required to, in turn, sell goods and services abroad and the percentage of these exports which are intermediate inputs of sales of goods and services in third

2: According to the Financial Survey of Families (2012), around 8% of Chinese households own financial assets in the form of shares, which figure reaches 60% for those owning bank deposits. In value terms, only 5% of total household wealth is of a financial nature.

economies[3]. According to the indicator constructed by the OECD[4], China is the economy which increased its degree of interconnectedness the most between 1995 and 2009[5].

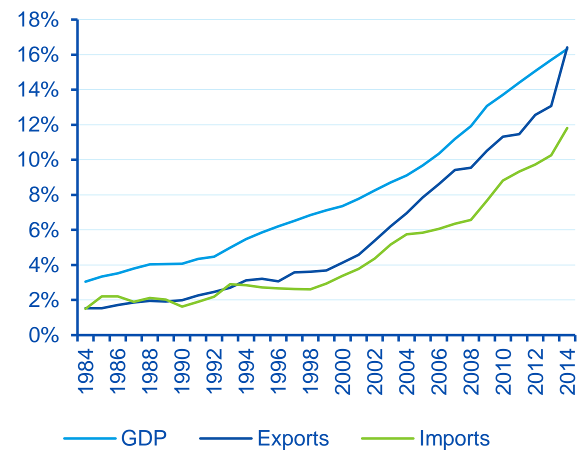
Since 2014, China has been the world's leading economy in terms of GDP, overtaking the US, with comparable positions in goods trade flows. In the mid-1990s China represented at least 6% of GDP and close to 3-5% of total exports and imports of goods; in 2014, it accounted for 16% of output and exports and 12% of imports. The nature of its trade structure means that, besides this, its share in global value chains is one of the highest among comparable countries in terms of size of economy and openness to trade.

Figure 5.2
Grade of connection through trade of goods and services, 1995=100



Share of imported inputs in the overall exports of a country and of its exported goods and services used as imported inputs to produce other countries' exports
Source: OECD (2015), Import content of exports (indicator)

Figure 5.3
China: share in World GDP and global trade of goods, % of total

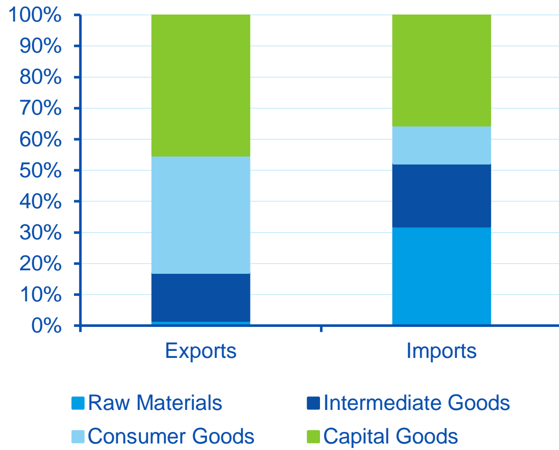


Source: BBVA Research, IMF and WTO

The fact that China imports over USD500bn a year in commodities (30% of the buying from abroad) puts some perspective on its role as one of the biggest sources of demand for these goods worldwide, for which reason any reduction in its level of activity places significant downward pressure on the prices of some of these, such as oil or copper.

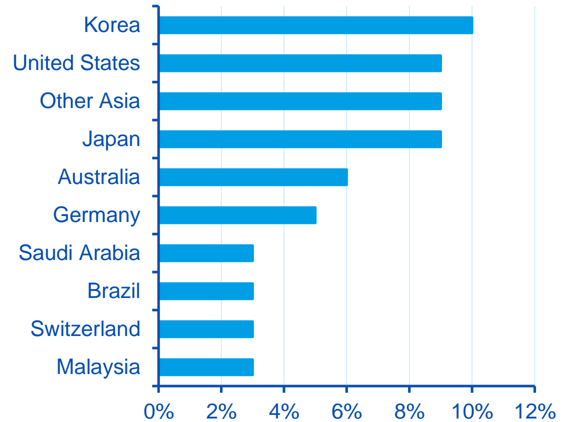
3: For further details on Global Value Chains, see the OECD at http://www.oecd.org/sti/global-value-chains-library.htm
4: Details at: https://data.oecd.org/trade/import-content-of-exports.htm
5: For the most recent period, it seems reasonable to assume that the intensiveness of China's share in global flows of goods and services has held up if one bears in mind that a little over one half of its imports and two thirds of its exports are capital and intermediate goods.

Figure 5.4
Structure of Chinese exports and imports by type of product, % of total, 2013



Source: BBVA Research, UNCTAD

Figure 5.5
China total imports by trade partner, % of total, 2013



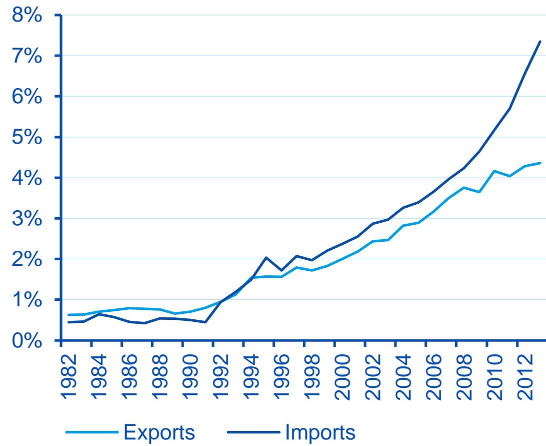
Source: BBVA Research, UNCTAD

The US, Japan and emerging Asia are China's key trading partners. The US accounts for 17% of total exports and 9% of imports, while Japan represents slightly below 10% of both flows. Hong Kong, Korea and other Asian countries such as India are also prominent among China's chief export destinations. Australia, Germany, Saudi Arabia and Brazil, on the other hand, are major import markets, above all due to the commodities they purchase, but also on account of the capital goods they buy. All in all, and despite the lack of overlap as regards some of its exports and import markets, China's centrality in world trade is very high, given that it does business with practically all of the countries in the world[6]. As was pointed out by the IMF[7], this leads one to suppose that, in the event of a shift in China's demand there is more likely to be bias towards a spreading of the correction via successive rounds of drops in demand from other countries rather than any moderating effect of absorption of the shock, which could only be the case for a select few of China's trading partners, essentially the oil producers.

With respect to exchanges of services, China has less of a trade presence in the world compared to goods, although the recent trends regarding this item are indicative of China's development from an industrial and export economy to one more oriented towards consumption and services, in keeping with the increase in the country's income per capita. Something over 4% of total services exports are provided by China, which is in turn responsible for 7% of imports worldwide. These are still low levels, but the growth is rapid, above all in the case of imports. Both shares are double what they were one decade ago, thus far exhibiting a high level of geographical concentration, mainly in terms of the flow of exports, where Hong Kong accounts for 40% of the total.

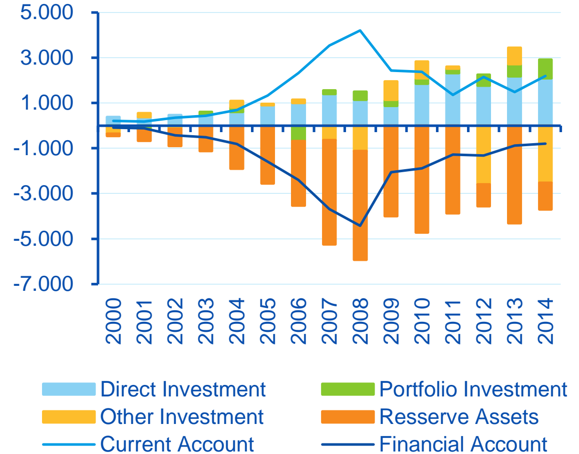
6: See Network Effects of International Shocks and Spillovers, IMF Working Paper, July 2015 https://www.imf.org/external/pubs/ft/wp/2015/wp15149.pdf
7: See previous note.

Figure 5.6
China: share in global services trade
% of total



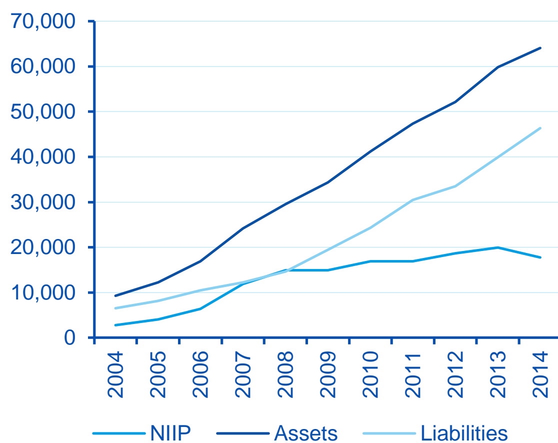
Source: BBVA Research, UNCTAD

Figure 5.7
China: balance of payments (USD100mn)



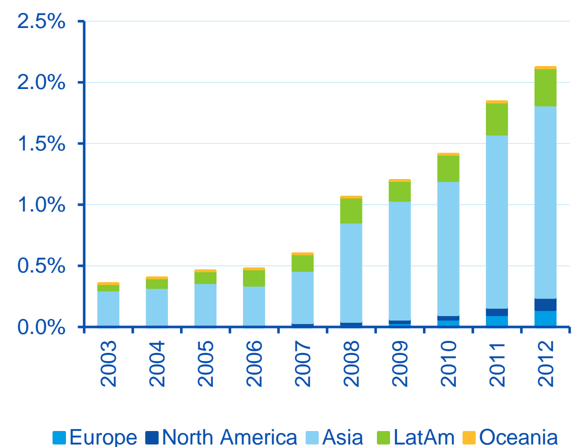
Source: BBVA Research, SAFE

Figure 5.8
China: Net international investment position (USD100mn)



Source: BBVA Research, SAFE

Figure 5.9
China outstock FDI , % world GDP



Source: BBVA Research, UNCTAD

Aside from the potential trade impact, which is evidenced by the size of China's economy and export and import flows, China also stands out for being the largest net holder of financial assets of the rest of the world (net creditor) as a result of persistently amassing current account surpluses[8]. A portion of these surpluses has been channelled out into the rest of the world in the form of portfolio investments (mainly), while another and more significant part has been set aside for building up reserves which, at the end of 2014, totalled some USD3.9trn.

Consequently, China's net international investment position (the difference between the value of its assets and liabilities in its dealings with the outside world) has been systematically positive, at around 20% of GDP in 2014. Asset purchases in the rest of the world, together with the appreciation in their value, have lifted

8: After reaching USD400bn in 2008, these have since stabilised at around USD200bn, or 2% of China's GDP.

China's investment position in the rest of the world to USD6.4trn, which more than outweighs the increase in liabilities in the form of external debt and which, according to SAFE, measured approximately USD1.6trn at the close of 1Q15 (barely 16% of GDP and 35% of the country's total liabilities with the world outside it).

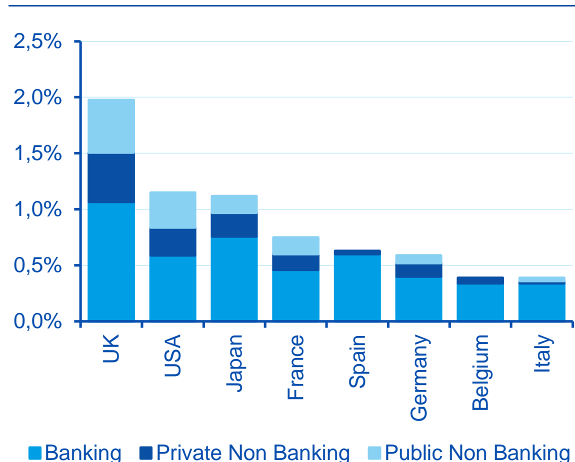
This leads us to draw a twofold distinction when trying to gauge the financial interconnection and potential contagion channels in the event of a crisis of this nature. The first lies with a potential sale of assets abroad and/or a scaling down of acquisitions by China for the sake of preserving financial stability at home and compensating for the recent outflow of capital in the wake of doubts over the robustness of the economic cycle. The second focusses on the structure of Chinese external borrowing to determine its financial interconnectedness with the global nodes of influence.

The lion's share of China's credit position is in the form of reserve assets, which represent over 50% of the country's overall assets in its external relations. A considerable part of these reserve assets is invested in US government debt; in fact, 20% of total US sovereign debt in foreign hands is owned by the Chinese. Since 2013 and in 2015 to date, buying from China has managed to offset net sales of US debt by all other foreign investors. Therefore any slowdown in the pace of buying from China or net selling process could prompt a spike in US yields which would imply tougher financing conditions worldwide.

In terms of foreign direct investment decisions, China's position is less awkward as regards the global situation (China's stock of FDI abroad represents scarcely 6% of the total worldwide and is mainly concentrated in Asia), even though a deterioration in the domestic economy might translate into less of an appetite to invest, in spite of the fact that the Chinese authorities have committed to buttressing the internationalisation process by buying business interests in regions with a low presence up to now (such is the case of the European Union).

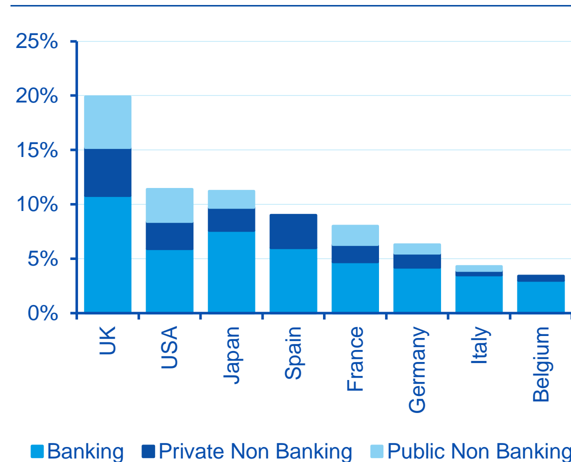
Turning to the share of global financial flows as measured on the basis of total external liabilities and drawing on BIS statistics[9], China hardly even accounts for 3% of world financial liabilities. Furthermore, intermediation for half of China's external debt is handled through the financial sector and represents 7% of the banking sector's liabilities globally, which is still a low percentage if compared with China's relative importance in economic activity and trade. The banking sectors in the UK, the US and Japan are, in that order, the Chinese financial sector's top external creditors but, in all these cases, with the exception of the UK, the exposure which this represents with respect to bank lending granted externally is modest (Figures 5.10 and 5.11).

Figure 5.10
Claims on China
(% of global liabilities)



Source: BBVA Research & BIS CBS Table 9E

Figure 5.11
Claims on China
(% of total claims held by each country)



Source: BBVA Research & BIS CBS Table 9E

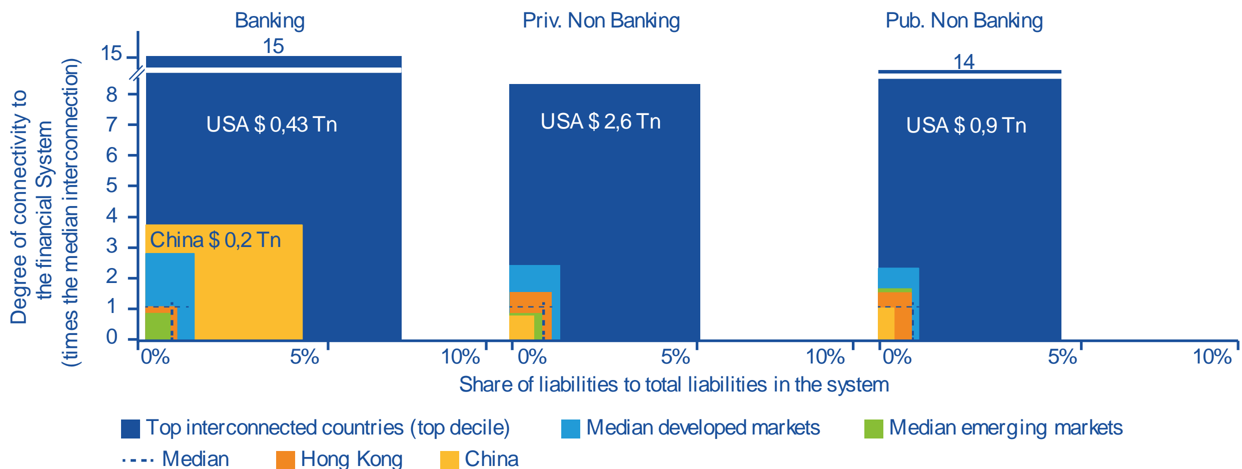
9: See https://www.bis.org/statistics/r_qa1509_hanx9e_u.pdf

Even so, as with the case of global flows of goods and services[10], the exposure to a financial shock emanating from China does not merely depend on the scale of the Chinese economy's financial liabilities, or who the holders of these liabilities are, but also on the degree of creditors' interconnectedness, their centrality within the world financial system.

Calculation of measures of interconnectedness, which are being developed by BBVA Research, is based on the number of financial links an economy has with the global system as a whole, both inbound (the country's liabilities) and outbound (assets) and these are weighted by the relative size of each exposure. This measure locates the degree of centrality of each country (node) within the whole but does not make it possible to establish the proximity of each of these nodes in relation to the centre of the system. To add in this aspect we weight the significance of each link according to its relationship with those clusters which have the highest degree of interconnectedness with the rest. The synthesis of the two metrics mentioned enables the fusion of the connectedness criterion with the degree of overall integration within the global financial system and gives us an idea of the capacity an economy (node) has for spreading contagion to the system as a whole.

The results for China (Figure 5.12) makes it clear that only if the shock affects the banking sector will the financial channel be able to take on global proportions: the interconnectedness of the Chinese banking sector with the world financial system comfortably outstrips the median value for EMs and is even ahead of the median for DMs, although it is a very considerable distance short of countries such as the US or even the group of the most highly financially interconnected countries.

Figure 5.12
Interconnectivity and exposure of financial systems as of 4Q14



Source: BBVA Research, BIS Consolidated Banking Statistics Table 9E

Potential impact of an economic activity shock in China

From analysing the channels for contagion mentioned above it may be deduced that the greatest risk to the global situation of deterioration in China's economic situation is from a contraction in activity which affects the rest of the world via trading and investment ties, whereas there is less vulnerability to purely financial contagion.

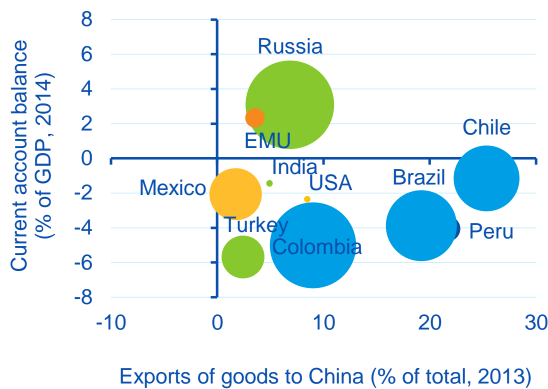
This can also entail an increase in global risk aversion, which would be more intense in the EMs, with an increase in sovereign bond spreads and a depreciation of their currencies given a possible retraction of

10: See IMF reference in note 6.

inflows of foreign capital. Those countries with greater trade exposure to China, and those relying more heavily on the commodity cycle and/or more dependent on sizeable disequilibrium in terms of their external position, could possibly experience worse relative responses, both economically and financially. The recent trends in the currency market support this pattern (Figure 5.13).

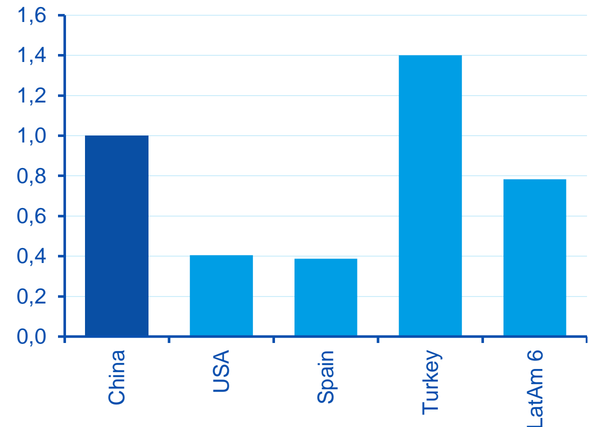
A marked correction in the pace of China's economic growth, together with an upturn in the perceived risk in the bulk of the EMs to levels on a par with those observed in 2008-09, could translate into a widespread contraction in economic activity across the world, but with a major difference among the various economies. In the US the deterioration in financial conditions would be mitigated by the view of the dollar as a safe-haven asset, whereas among the EMs, and especially in those that are more financially vulnerable owing to their reliance on external capital flows, the impact would be greater, even possibly worse than the initial shock from China[11].

Figure 5.13
Exposure to China and foreign funding needs*



* Size of bubble: magnitude of currency depreciation against USD since May15
Source: BBVA Research, UNCTAD, IMF

Figure 5.14
Impact on GDP due to an activity and risk premia shock triggered by China, %



Source: BBVA Research

11: Calculation of impacts based on the BBVA Research GVAR model.

6 Risks become balanced with lower growth projections

Risks to growth mainly concentrate on the stock market crash and its spillover effect to the real economy, continuous deflation risk as well as increasing capital outflows. After we lowered growth projections, risks to our base scenario are now more balanced than three months ago.

The transmission channels from the stock market crash to the real economy include: first, suspension of IPOs will deteriorate firms' financial conditions; second, the sharp correction of stock prices will have "wealth effect" on retail investors, forcing them to cut back their consumption; third, some firms use stock shares as collaterals to borrow from financial institutions, the depreciation of their value could exacerbate financial squeeze for these firms.

Nor did deflation risk abate. The deflation of the PPI has lasted for 40 months due to the prevalent overcapacity problem in several industries, which could be exacerbated by the further drop of global commodity prices. The combination of the increasingly strengthening US dollar and domestic growth slowdown could heighten capital outflows in the coming months. In particular, a strengthening US dollar could continue to act as a pull factor to induce investors to move away from risky assets in China, which seems all the more in the aftermath of the stock market crash. Thus, China's authorities would be faced with a policy dilemma between supporting growth (lowering interest rate) and reining in deflationary pressure on the one hand, and reducing the risk of abrupt capital outflows on the other hand.

But perhaps the most ominous concern is that fact that the recent market crash will add uncertainty to China's ongoing capital account liberalization. After the market crash exposed a number of serious flaws in China's regulatory framework, policymakers could become reluctant to further open the domestic market to foreign institutional investors. On the contrary, we think that liberalizing China's capital account could help balance the dominance of retail investors, making the market more robust to "herd behavior" and allowing Chinese households to diversify their investments. The stalling reforms in the financial sector will unavoidably hinder the efficiency of capital allocation and thereby bring immeasurable harm to China's growth in the long run.

7 Tables

Table 6.1

Macroeconomic Forecasts: Gross Domestic Product

Average, %	2012	2013	2014	2015	2016
United States	2.3	2.2	2.4	2.9	2.8
Eurozone	-0.8	-0.4	0.9	1.6	2.2
Spain	-2.1	-1.2	1.4	3.0	2.7
UK	0.7	1.7	2.8	2.5	2.3
Latin America *	2.8	2.5	0.8	0.6	2.1
EAGLES **	5.8	5.6	5.3	4.9	5.3
Asia Pacific	5.7	5.9	5.7	5.8	5.8
Japan	1.8	1.5	0.0	1.3	1.2
China	7.8	7.7	7.4	6.8	6.2
Asia (exc. China)	4.1	4.5	4.3	4.9	5.0
World	3.4	3.4	3.4	3.5	3.9

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

Table 6.2

Macroeconomic Forecasts: Inflation

Average, %	2012	2013	2014	2015	2016
United States	2.1	1.5	1.6	0.6	1.9
Eurozone	2.5	1.4	0.4	0.1	1.3
Spain	2.4	1.4	-0.2	-0.2	1.4
UK	2.8	2.6	1.5	0.3	1.7
Latin America *	7.8	9.2	12.6	13.5	13.5
EAGLES **	5.2	5.2	4.6	4.8	4.5
Turkey	8.9	7.6	8.9	7.3	7.2
Asia Pacific	3.9	4.1	3.3	2.7	3.3
Japan	0.0	1.6	2.7	1.0	1.6
China	2.6	2.6	2.0	1.7	2.0
Asia (exc. China)	4.8	5.2	4.4	3.5	3.9
World	4.5	4.2	3.9	3.8	4.1

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

Table 6.3

Macroeconomic Forecasts: Exchange Rates (Annual Average)

		2012	2013	2014	2015	2016
Eurozone	**USD/EUR**	0.78	0.75	0.75	0.96	0.94
Japan	**JPY/USD**	79.8	97.5	105.8	124.3	131.7
China	**CNY/USD**	6.31	6.20	6.14	6.25	6.22
UK	**GBP/USD**	1.59	1.56	1.65	1.47	1.60

Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

Table 6.4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	2012	2013	2014	2015	2016
United States	0.25	0.25	0.25	0.50	1.50
Eurozone	0.75	0.25	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	6.00	5.60	4.60	4.60
Hong Kong	0.50	0.50	0.50	0.75	1.75
India	8.00	7.75	8.00	7.50	6.75

Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

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This report has been produced by the Emerging Markets Unit:

Chief Econmist for Asia
Le Xia
xia.le@bbva.com.hk

Jinyue Dong
jinyue.dong@bbva.com.hk

Carlos Casanova
c.casanova@bbva.com.hk

Betty Huang
betty.huang@bbva.com.hk

Sumedh Deorukhkar (India)
sumedh.deorukhkar@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jimenez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo.lopez@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Global Areas

Economic Scenarios
Julián Cubero Calvo
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research
95/F, International Commerce Centre
One Austin Road West
Kowloon, Hong Kong
Tel. + 852-2582-3111; Fax. +852-2587-9717
research.emergingmarkets@bbva.com.hk
www.bbvaresearch.com