The 10-second briefing

The end of the 'free lunch'

China Economy

- The slide in the CNY is an inevitable policy choice in response to deteriorating credit conditions and rising tapering pressure
- How far the CNY will go depends on how much money needs to be printed to fill the void left by the Fed
- The central bank's ammo is running low; averting a financial crisis now requires very delicate policy moves

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■ **Summary**

The Fed's QE and low-interest rate policy has been a big 'free lunch' for China. The tremendous amount of dollar inflows has enabled the PBOC to print a lot of money – funding its credit expansion and fiscal stimulus programme without compromising its currency stability.

USD/CNY: pair of chopsticks. If USD liquidity keeps rising, CNY liquidity could match this rise. High yields in China have encouraged massive money inflows into the country to chase those yields. There has been no real pressure on the pair. If, however, USD liquidity stops rising, CNY liquidity will have to follow. Otherwise the pressure would be on the CNY to depreciate. The question is: can CNY liquidity afford to dwindle in the face of ongoing credit stress in China?

Money outflows are possible in China, as the leveraged money chasing high yields would be withdrawn. Not only is the Fed's policy normalisation a key catalyst for outflows, investors are also getting concerned about credit conditions in China, realising that the yield advantage is merely a reflection of the credit risk premium. The money outflows via the country's capital account may well exceed the structural money inflows via its current account.

We believe the PBOC will have to keep printing money to ensure the economy stays afloat and not care too much about downward pressure on the currency. This option could at least buy some time for the PBOC to fight the fire. Any other conventional measures to deal with the credit issues, such as bank recapitalisation, would still require a lot of money to be printed. The market expectation for CNY appreciation is deeply entrenched, however. If the market thinks the CNY will drop substantially, it would start pulling money out. If that happened, the PBOC would have to print even more money to fill the void; and this would lead to even more downward pressure on the CNY, and hence even more money would be pulled out. This downward spiral could easily lead to a full-blown currency and financial crisis.

A war-chest of forex reserves may be of little use. The market tends to think that China can use its forex reserves any time to stabilise its currency or take care of its financial troubles. But selling forex reserves is a painful exercise. If the PBOC did sell forex reserves, it would have to buy back its own money. This would mean China's monetary base would shrink and the massive amount of money created in the past would have to be destroyed.

Foreign debt in real terms would escalate. China's total outstanding foreign debt is over USD823bn at end-3Q13, of which 77% was short-term debt and had mostly been raised through Hong Kong. Many borrowers rely on CNY cash flows to service debts dominated in USD. CNY depreciation would make life even tougher for the borrowers.

We look for a 10% drop in the CNY by end-2015. How far the CNY will go depends on how much money needs to be created in order to manage the credit pressure and to fill the void left by the Fed. Our base-case forecast is for a further 10% correction in the USD/CNY by end-2015 (6.50 by end-2014 and 6.83 by end-2015). We are trimming our GDP forecasts to 7.1%, from 7.5%, for 2014, and to 6.9%, from 7.2%, for 2015, on credit setbacks and disappointing demand in the emerging world.

Policy easing likely but not without a cost. We see a case for monetary easing starting in 3Q14, mainly through reserve-ratio cuts. We are pencilling in 50bps cuts in the RRR in each of 3Q14 and 4Q14, and two similar cuts for 2015. But any easing would put the CNY under pressure. The bottom line is that there is no easy way out of the problems China is facing.

The end of the 'free lunch'

We look at the USD/CNY as a pair of chopsticks. If USD liquidity keeps rising, CNY liquidity could match the rise and there would be no real pressure on the pair. If, however, USD liquidity stops rising, CNY liquidity would have to follow. Otherwise the pressure would be on the pair to rise. The question is: can CNY liquidity afford to dwindle in the face of ongoing credit stress in China?

Will money inflow still be a trend?

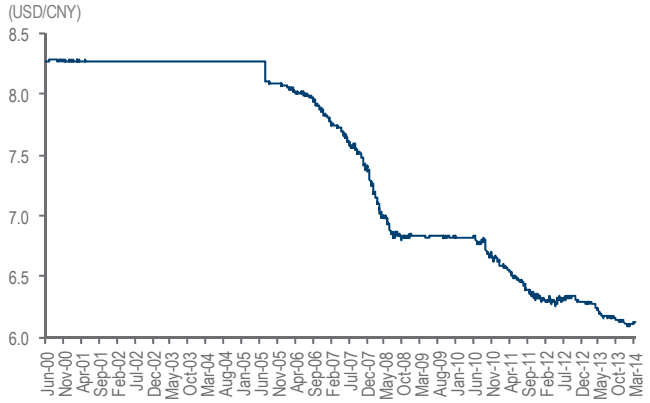
There are many interpretations about the most recent CNY depreciation. The most popular is that it is an engineered move by the PBOC to fend off speculators who keep bringing 'hot' money into China. The USD/CNY has been consistently on the way down since July 2005, except between July 2008 and June 2010, when the USD/CNY was held more or less fixed. This one-way traffic has encouraged sizeable money inflows on an unhedged basis, especially when the Fed has printed over USD3tn in new money over the past 5 years.

Although the Chinese authorities have not explained their policy intent in a transparent manner, the PBOC said that the sell-off in the CNY was a reflection of market forces and should not be over-interpreted. None of these explanations is sufficient to us, however. Hot money has been going into China for the past 10 years. It would not take a lot of wisdom to introduce a 2-way risk mechanism to fend off speculation. Why has it taken so long for the PBOC to figure this out and deploy it?

As the Fed's tapering plan started in January, getting USD funding is going to gradually become more difficult and expensive over time. On the other hand, China's credit conditions have been worsening every day. Eventually, the market will demand a much higher risk premium for holding the CNY, so that the one-way wager on the USD/CNY would be getting less and less attractive. The favourable risk-reward profile will have to go through some drastic changes over the next few years.

The risk going forward may no longer be money inflows into China. On the contrary, it may well be money outflows, in our view. The money outflows via the country's capital account may well exceed the structural money inflows via its current account.

■ One-way traffic for the USD/CNY set for a turn?



Source: CEIC, Daiwa

The Fed and the PBOC – Siamese twins

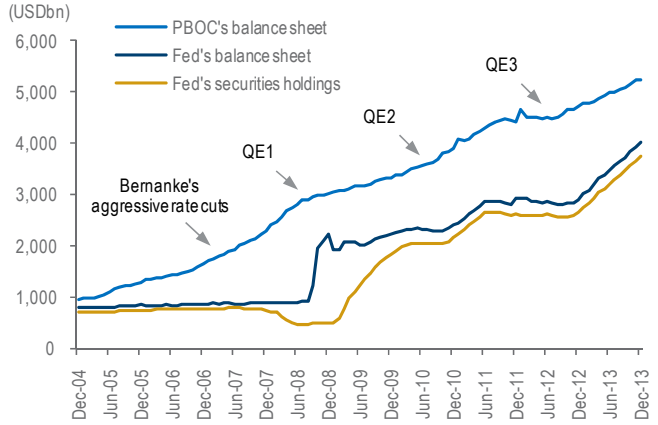
So, what is the true motive behind the currency move? Is there something the market does not know or has been misguided to believe? Are the Chinese authorities changing their commitment to a strong exchange rate, and if so why?

In our previous reports (*G3 recovery versus Fed tapering*, *Fed's exit, China's structural slowdown and a paradigm shift* and *Heading toward the exit*), we discussed at great length the risks of money outflows from Asia/China on the back of the Fed's tapering. We will not go through them here again. Rather, we would suggest our readers examine China's current monetary conditions carefully. We also warned against growing credit issues in China – shadow-banking, LGFVs, the trust market, etc. We would advise investors to look at the whole credit situation not in isolation, but in the context of China's balance of payments, currency relationship and monetary policy and how it is connected to the Fed's monetary policy.

The chart below shows the balance sheets of the Fed and the PBOC. Since QE1, the Fed's balance sheet has expanded by over USD3tn, which is not a secret. The

secret is that the PBOC's balance sheet has also expanded by over USD3tn. It is not a coincidence. The Fed's 3 rounds of QE produced enormous amounts of fresh USD money supply. A lot of this money found its way into Asia/China, predominantly via capital not trade channels. In a pure market-driven economy, the CNY would have appreciated significantly against the USD in order to insulate the country against the onslaught of these money inflows. This is what economies like Australia have done.

■ **Aggressive US policy has led to massive money printing in China**



Source: CEIC, Daiwa

Under normal market-driven circumstances, the CNY would have easily risen by at least 30-40%. In reality, of course, China has chosen to keep the CNY on a slow pace of appreciation. The result has been a massive amount of money printed by the PBOC in order to build forex reserves. The money that has been printed shows up as 'base money' (a liability item) under the PBOC's balance sheet. The forex reserves show up as a 'foreign asset' (an asset item) under the same balance sheet. At the end of December 2013, these 2 items were exactly CNY27tn. The implications here are highly important.

■ **PBOC's balance sheet as of December 2013**

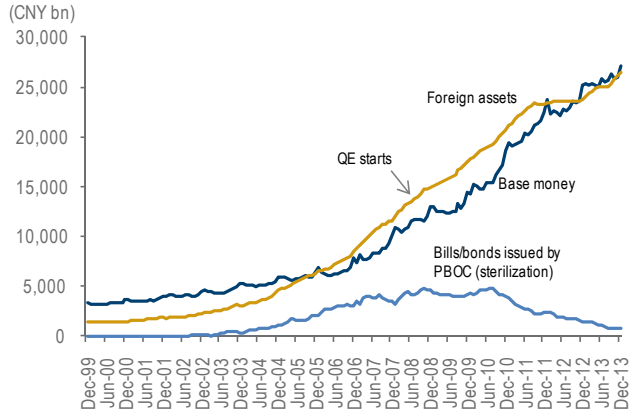
Assets	CNYbn	Liabilities	CNYbn
Foreign assets	27,223	Base money	27,102
Claims on government	1,531	Deposits of financial institutions excl base money	133
Claims on other institutions	2,208	Bond issues	776
Others	766	Foreign liabilities	209
		Government deposits	2,861
		Own capital	22
		Others	624
Total assets	31,728	Total liabilities	31,728

Source: CEIC, Daiwa

First, China's monetary base has been literally fully funded by foreign money inflows. The change of these money flows direction will have a direct and severe impact on its monetary base and hence its economy.

Second, China has more or less followed the Fed to conduct its own version of QE. The Fed has printed new money to purchase domestic securities. The PBOC has printed the same amount of money to purchase foreign securities. The Fed called in QE to bolster its subdued economy. The PBOC has done the same. But the money multiplier is about 4 times in China, twice faster than in the US. Risk appetite is also a lot higher and regulatory infrastructure is a lot weaker in China. These differences have given rise to many credit problems in China.

■ **PBOC's balance sheet: key variable changes over time**



Source: CEIC, Daiwa

Third, the well-known CNY4tn fiscal stimulus programme launched by China in the aftermath of the Global Financial Crisis (GFC) in 2008 required a lot of money to be printed to fund the spending. The Fed's QE has actually allowed the PBOC to turn on its printing press without causing any damage to the CNY. In other words, without the help from the Fed, China would not have been able to deliver the stimulus so easily.

Fourth, the PBOC has been releasing new money by buying back central-bank papers (the so-called sterilisation bonds) from the market. The level of these bonds outstanding in the market reached a peak of CNY4,749bn in July 2010. Since then, it has dropped consistently to CNY776bn in December 2013. In other words, by buying back these bonds, it has allowed the PBOC to print an extra CNY4tn of money over the past three-and-a-half years. But this also means that much of its ammo has been used up.

When the Fed stops printing, can the PBOC afford to stop too?

The Fed's tapering and its eventual QE exit over the next several years represent a paradigm shift of all these forces, in our view. When the Fed starts scaling down its balance sheet, money outflows from Asia/ China would be quite probable, as the global tide of USD liquidity would retreat, albeit slowly, and the leveraged money chasing high yields in China would be withdrawn. The 'Siamese-twins' dynamics described above mean that the PBOC's balance sheet may have to go through a similar scale-down process. In other words, some of the money that has been created in the past may have to be destroyed.

At the very least, assuming that the Fed's balance sheet stops expanding, can the PBOC afford to stop as well? Can money growth afford to slow down when millions of borrowers need to be fed with new money every day? A long queue of borrowers – trust vehicles, LGFVs, corporates, developers, shadow-bank players, etc. – is hungry for money. Many of them routinely borrow new debts to pay old ones, meaning the need for refinancing will keep rising over time. Just for the trust market, for example, the size for refinancing is about CNY5.2tn this year versus just CNY3.3tn last year.

▪ Trust market's overall redemption schedule (approximately the size for refinancing)

Source: WIND

Something has to give — and that something is the currency

The USD/CNY resemble a pair of chopsticks. If USD liquidity keeps rising, CNY liquidity could match this rise. High yields in China have encouraged a lot of money inflows into the country to chase those yields. As such, there has been no significant pressure on the exchange rate. However, if USD liquidity stops rising, CNY liquidity has to follow to stop too. Otherwise, the pressure would be on the CNY to fall. At the same time, investors are becoming concerned about credit conditions in China, realising that the yield advantage is merely a reflection of credit risk premium. If yields are not worth chasing, money would be pulled out.

In our view, the policy choices for the PBOC are down to 2. First, it could keep the USD/CNY stable but at the expense of credit. If the PBOC does not supply enough money to the market today, there will be hundreds or even thousands of defaults tomorrow.

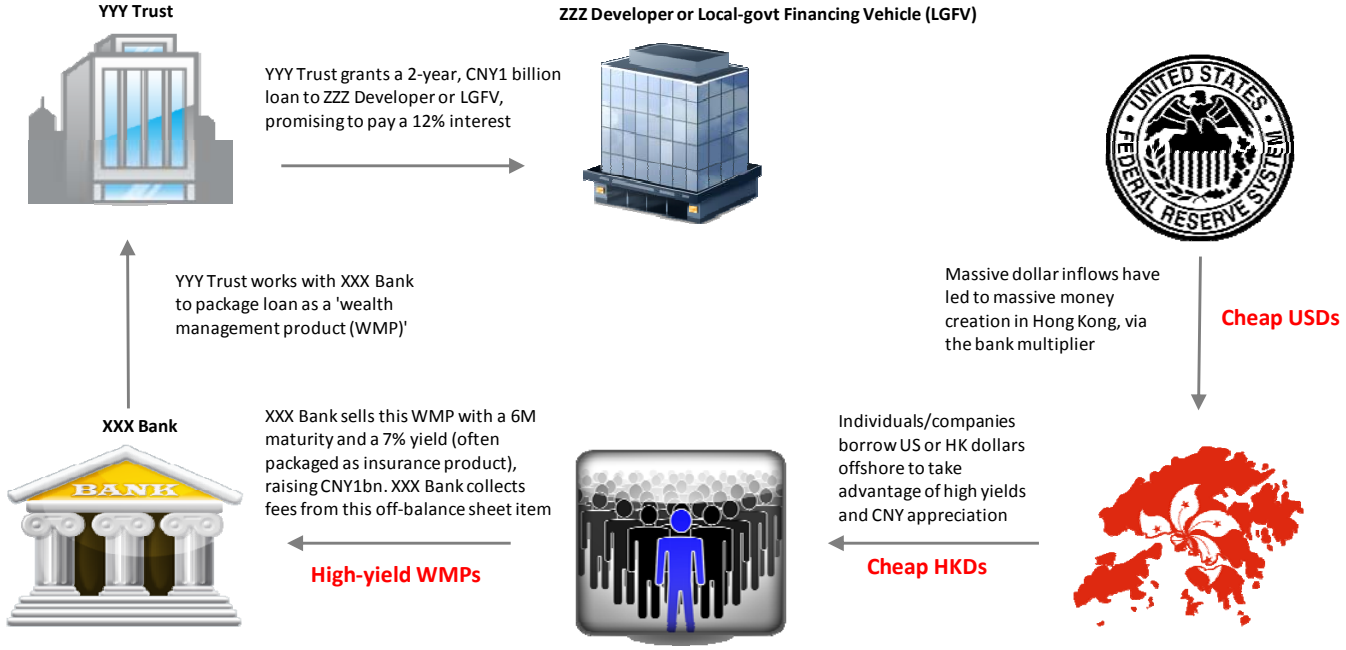
Second, it can keep printing money to satisfy those hungry borrowers and to ensure the economy stays afloat and just ignore the downward pressure on the USD/CNY.

These choices are stark. But option 1 would easily result it an eminent credit and financial crisis. Option 2 could at least buy some time for the PBOC to fight the fire. It is at least the lesser of the 2 evils.

Option 2 could have serious downside, however. The market has been expecting the CNY to appreciate over many years. This expectation is deeply entrenched and has encouraged tremendous amounts of money inflows into China on an unhedged basis. If the market thinks the CNY will decline by 10% or 20% in a year, it would start pulling money out.

If that happens, the PBOC would have to print even more money to fill the void. And if more money is printed, then this would lead to even more downward pressure on the currency, and hence even more money would be pulled out. One can imagine this downward spiral could easily result in a full-blown currency and financial crisis. Instead of one fire, the PBOC may find itself fighting two fires.

■ The global web of China's trust instruments

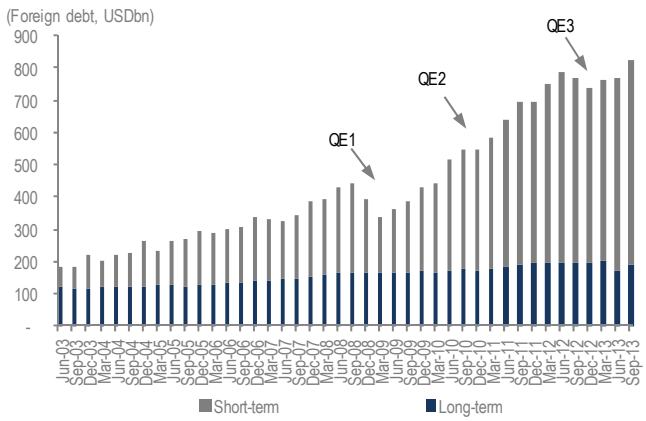


Source: Daiwa

But currency slide is a risky proposition

In addition, China has borrowed a substantial amount of foreign debt, especially since QE1. The country's total outstanding foreign debt was USD823bn by the end of September 2013, of which 77% was short-term debt and 60% had been raised since QE1. Most borrowers rely on CNY cash flow to service debts dominated in USD, HKD or other foreign currencies. So the foreign debt level in real terms will escalate.

■ China's foreign debt has reached USD823bn



Source: CEIC, Daiwa

The bulk of the foreign debt has been raised through Hong Kong's bank channels. Loans to China's non-bank sector have reached HKD3,486bn (USD450bn). Since QE1, 84% of the loan creation in Hong Kong has been taken by these Chinese borrowers.

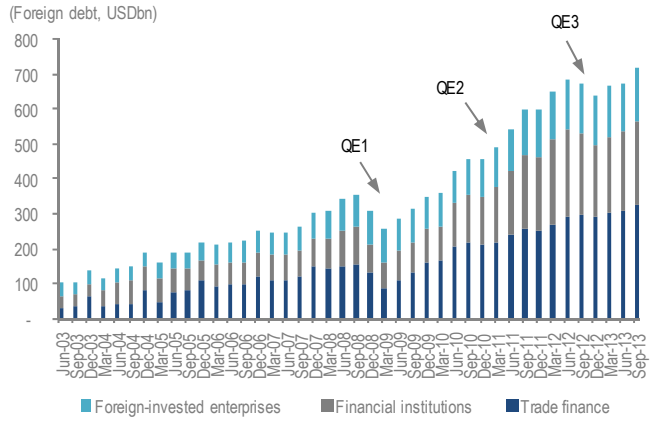
Although there are capital controls in China, Hong Kong is the most convenient and efficient centre to help channel money into China, especially when it can easily raise billions of USD globally at very low cost. The existence of the currency peg makes it much easier and highly efficient. The peg tends to attract billions of USD money inflows globally on an unhedged basis.

Out of the USD823bn in foreign debt, USD327bn is trade finance, which is interesting because the growth of this trade finance cannot be explained by the normal trade growth over the past 5 years. For many SOEs or financial institutions in China, raising USD or HKD debt is relatively easy. The dollars are then converted into CNY, which is placed on high-yield assets in China.

But for SMEs in China, it is much more difficult. However, getting trade finance from Hong Kong is completely legitimate. Practically, SMEs would inflate their export revenue, borrow trade loans from Hong Kong and sell HKD or USD to the PBOC in return for CNY liquidity. Money would in turn be invested in high-yield assets in China. Our calculation shows that inflated exports just between China and Hong Kong have amounted to over USD310bn. It also means that

about one-third of China's current-account surplus since QE1 has not really come from trade incomes but pure short-term speculative money inflows.

■ **Foreign debt is concentrated in trade finance and loans to FIs**



Source: CEIC, Daiwa

One can therefore imagine that these dollar borrowers can be easily squeezed by: 1) CNY depreciation, and 2) worsening credit conditions in China (meaning some money may never return to the lenders or investors).

Either case, Hong Kong is ultimately exposed. Apparently, trade finance is supposed to be high-quality credit. Under this credit chain, however, high-quality can easily turn into poor-quality credit.

Can the PBOC sell forex reserves?

The market tends to think that China has a war-chest of forex reserves, at USD3.8tn, and it can use these at any time to stabilise its currency or take care of all its financial troubles. But selling forex reserves does not come without a cost. It is not because it would have to dump many US treasuries in the market; the real problem is that, when it sells forex reserves, what would it buy?

China would have to buy back its own currency, which means the liability side of the PBOC's balance sheet or its monetary base would have to shrink. The massive amount of money created in the past would have to be destroyed. The money multiplier that has worked to multiply money would have to work the other way round. This would be a nightmare scenario that many central banks would try to avoid.

What bullets are left to fire?

There is no doubt in our minds that China is facing a serious credit challenge. To avert a credit crisis, the government must find a way to keep creating money. This is probably the only tool available to policy-makers. The US, Europe and Japan have dealt with similar credit crises by injecting tremendous amounts of money into their banking systems. Any other conventional measures to deal with the credit issues such as bank recapitalisation would still require a lot of money to be printed and injected into the system.

There are a few policy tools still available for Chinese policy-makers. First and foremost, the required reserve ratio (RRR) could be cut to allow banks to create more liquidity. Likewise, interest rates could also be cut to reduce financing costs. However, these 2 options would still exert downward pressure on the currency.

Examples from India and Indonesia also tell us that, in the case of money outflows, the central bank cannot ease its monetary policy easily. To discourage money from leaving, the central bank may have to raise interest rates in order to offset the rising risk premium.

Fiscal stimulus could be called in again to support growth and keep many borrowers afloat. But a new round of government-led spending would also require new money to be printed. Moreover, the economy is already suffering from excess capacity due to the aggressive stimulus of the past. Banks are already littered with potential bad debts. How much more banks can take is a big question.

If all policy tools have been tried and exhausted, one would think of imposing stricter capital controls in order to stop or at least slow down money outflows. This draconian measure could help stop the bleeding. However, since Hong Kong has provided the bulk of dollar credit to China, if banks in Hong Kong cannot get their money back and money starts leaving the city, a banking crisis in Hong Kong would quickly take hold.

■ China: what bullets are left to fire?

Bullets	Pros	Cons
Required reserve ratio (RRR) cuts	-Freeing up domestic liquidity within the banking system	-Banks would have to increase leverage, counter to the principle of deleveraging -Surge in CNY liquidity could put downward pressure on CNY
Interest rate cuts	-Reducing financing costs	-Difficult to achieve without expanding liquidity supply (RRR cuts) -Cons are the same as above
Interest rate hikes	-Helping to stop money outflows	-Exacerbating credit stress
Fiscal stimulus	-Sustaining growth and credit bubble -Maintaining short-term market confidence	-Banks are already troubled by credit risks and will have to take some more -The economy is already suffering from excess capacity due to the aggressive stimulus of the past -Would still need to be funded by money printing
Selling forex reserves	-Protecting the CNY and stabilising market confidence	-The PBOC would have to buy back a massive amount of CNY from the market, causing the monetary base to shrink and destroying money/credit
Currency swap arrangements with other central banks	-Increasing access to liquidity and foreign currencies	-Only effective in the short term -Much less effective in the event of contagion
Currency depreciation	-Foreigners would help foot the bill	-Change in appreciation expectations could trigger more money outflows -Real foreign debt would shoot up
Tightening capital controls	-Stopping or at least slowing money outflows	-Foreign investors might panic -If money could not return to Hong Kong, the city would face a banking crisis

Source: Daiwa

Forecast revisions

None of the possible scenarios makes for pleasant reading. It appears to us that the China authorities have chosen to let the currency go in order give themselves room for manoeuvre in terms of policy options to manage the credit pressure. This strategy would imply further monetary relaxation in the future.

Forecasting the USD/CNY direction is very challenging at this stage. How far the USD/CNY will go depends on how much money needs to be created in order to manage the credit pressure and fill the void left by the Fed.

Our base-case forecast is for a further 10% upward correction of the USD/CNY rate by the end of 2015 (CNY6.50:USD1 by end-2014 and CNY6.83:USD1 by end-2015).

Presumably, and hopefully, this would be a gradual, orderly slide for the CNY. Our CNY6.83:USD1 forecast also implies that all of the CNY appreciation since QE1 would have to be completely erased.

We would also expect the PBOC to sell some forex reserves in order to avoid a sharp slide in the CNY, but a wholesale liquidation of forex reserves is highly unlikely.

Credit problems continue to be the major drag on China's GDP growth. The PMI readings (both official and HSBC) for January and February have been disappointing, reflecting the credit setbacks, in our view. Moreover, the PMI for new export orders has been below 50 for 3 consecutive months. While the demand recovery in the G3 is encouraging, the demand picture in the emerging world has been deteriorating and is offsetting the gains in the developed world. As a result, we are trimming our China GDP forecasts to 7.1% YoY, from 7.5% YoY, for 2014, and to 6.9% YoY, from 7.2% YoY, for 2015.

With both domestic and external demand indicators remaining weak, there is not enough impetus from demand to drive up prices, in our view. The China government will ensure enough credit is created, but we believe most of that credit will go towards supporting debt refinancing rather than real economic activity.

Hence, we see inflation as a receding threat. We are cutting our CPI forecasts to 2.5% YoY, from 3.2% YoY, for 2014, and to 2.3% YoY, from 2.5% YoY, for 2015. Likewise, we revise down our PPI forecasts to -1.0% YoY, from -0.3% YoY, for 2014, and to 0.5% YoY, from 1.0% YoY, for 2015.

At the National People's Congress meeting in March, the government left its GDP growth target for 2014 unchanged at 7.5%. In our view, this target will be difficult to achieve in the present circumstances. However, the government seems to want the market to believe in this 7.5% figure, perhaps because it recognises that confidence is very fragile right now. Financial deleveraging seems to be giving way to a relatively loose monetary and fiscal policy, which reflects the government's concerns about credit. There is a desire among the authorities to ensure sufficient money is created to satisfy refinancing needs. Premier Li also hinted at a further fine-tuning (relaxation) of policy to support economic growth when necessary.

All things considered, we believe policymakers will have to consider further monetary easing in the second half of 2014. While interest-rate moves remain

unlikely, we think cutting the RRR would be one option. We are pencilling into two 50bps cuts in the RRR by year-end (one in 3Q14, another in 4Q14), and two more cuts of a similar magnitude for 2015.

Any moves to relax the monetary grip will likely be welcomed by the market, at least initially. However, the pressure on the currency cannot be ignored. Policymakers will have to balance the pros and the cons of each move to ease monetary policy. Cutting the RRR is a viable option but cannot be done too often. And if such moves backfire, the PBOC may have no other choice but to tighten.

As we see it, the bottom line is that there is no easy way out of the problems now facing China. Any policy action or reaction by the government will require careful calculation of the attendant risks.

Making predictions is very difficult at this stage. We can only watch each move taken by the China authorities to try to ascertain what is likely to happen next.

■ **Daiwa's economic forecasts for China**

		1Q13	2Q13	3Q13	4Q13	1Q14E	2Q14E	3Q14E	4Q14E	2013	2014E	2015E
Real GDP	YoY %	7.7	7.5	7.8	7.7	*7.4*	*7.2*	*7.0*	*6.9*	7.7	*7.1*	*6.9*
CPI	YoY %	2.4	2.4	2.8	2.9	*2.5*	*2.3*	*2.5*	*2.7*	2.6	*2.5*	*2.3*
PPI	YoY %	-1.7	-2.7	-1.7	-1.4	*-1.9*	*-1.1*	*-0.5*	*-0.4*	-1.9	*-1.0*	*0.5*
Fixed assets investment (nominal, ytd)	YoY %	20.9	20.1	20.2	19.6	*19.2*	*18.5*	*18.0*	*17.5*	19.6	*17.5*	*16.5*
Retail sales (nominal)	YoY %	12.4	13.0	13.3	13.5	*13.7*	*13.6*	*13.8*	*14.1*	13.1	*13.8*	*13.5*
Industrial production	YoY %	9.5	9.1	10.1	10.0	*9.4*	*9.2*	*9.1*	*8.9*	9.7	*9.1*	*8.9*
Exports	YoY %	18.3	3.8	3.9	7.4	*0.4*	*7.7*	*8.7*	*8.5*	7.9	*6.5*	*7.0*
Imports	YoY %	8.6	4.9	8.5	7.1	*10.1*	*9.4*	*8.5*	*8.1*	7.3	*9.0*	*8.0*
Trade balance	USDbn	43.5	65.7	61.5	90.5	*-3.2*	*63.1*	*67.2*	*100.0*	261.4	*227.0*	*221.7*
Exchange rate (end-of-period)	CNY/USD	6.27	6.18	6.15	6.10	*6.20*	*6.30*	*6.40*	*6.50*	6.10	*6.50*	*6.83*
M2	YoY %	15.7	14.0	14.2	13.6	*13.3*	*13.3*	*13.2*	*13.0*	13.6	*13.0*	*12.0*
1-year base lending rate	% pa	6.00	6.00	6.00	6.00	*6.00*	*6.00*	*6.00*	*6.00*	6.00	*6.00*	*6.00*
1-year deposit rate	% pa	3.00	3.00	3.00	3.00	*3.00*	*3.00*	*3.00*	*3.00*	3.00	*3.00*	*3.00*
Required reserve ratio	%	19.5	19.5	19.5	19.5	*19.5*	*19.5*	*19.0*	*18.5*	19.5	*18.5*	*17.5*
Fiscal balance	% of GDP									-1.9	*-2.1*	*-2.2*

Source: CEIC, Daiwa forecasts

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