

Macro Salon Session Notes

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Questions from our BNYM moderators are in **blue**. Answers from panelists are in **black**.

China Outlook: Leaving the World Behind

Panelist:

Chen Long, Co-Founder & Partner, Plenum

Moderator:

Geoff Yu, Senior EMEA Markets Strategist, BNY Mellon

The government set a rather conservative target for growth and markets know that in reality this year's number will be well above 6%. Nonetheless, the PBoC's language often talks about the economy still being in a recovery phase. In your view, what is the general outlook and in particular, what are some of the biggest challenges with respect to the recovery?

- The recovery in China has been a straightforward story driven by a few things: (1) industrials, (2) exports – China normalized faster than the rest of the world, and (3) domestic demand, especially the property market.
- In every Chinese recovery, the bounce back in property markets leads all else. There was a sharp rebound in property sales. There was a slight slowdown in construction starts and real estate fixed asset investment, but property sales continue to excel.
- The government growth target is quite conservative. Beijing set a national growth target of 6%. The market, however, believes China will grow between 8-10%. So why is the national growth target so low? Policy. It is now a habit that the target itself is lowered by 0.5pp every two years. Beijing already has the 2022 target in mind, which should be 5.5% - if a target were set this year for 8% (which is likely to be the realized level) then there would be too much growth volatility. Taking the longer-term view, it's convenient that growth targets are set higher before there is a convergence to the 4.7% 'target' which should achieve a doubling of GDP by 2035.
- The key takeaway from specialists is that the market should not fret over a relatively conservative growth target of 6%.

Guo Shuqing, the Chairman of the CBIRC, talked about the real estate market approaching a bubble. Banks are now being told to rein in lending to real estate or deleverage outright. Why are property prices not going down and is there a risk the PBoC will over-tighten?

- The property market is not going down because tightening measures are not that harsh. Household debt has grown 14% YoY, roughly the same as last year.
- There are concerns of intervention but there has yet to be anything material. The government's target is not to correct prices, rather to stabilize and to stop overheating cities from burning out. The ultimate target is to have a smooth growth of property prices of ~4-5% YoY.

Despite having ample goods surpluses and a lack of a services deficit, on top of passive inflows into China's bond markets, the renminbi is weakening. What do you see as the bigger driver here, higher US real yields or more avenues for outflows for mainland investors?

- The main driver for USD/CNY is the dollar's direction: through the recent cycle, its dollar exchange rate was lagging the DXY most of the time and hit a three-year high, with the renminbi likely peaking around lunar new year.
- The CFETS basket, meanwhile, has been trading in a narrow range. Overall, this is an acceptable state of affairs and the PBoC is not concerned about the exchange rate per se, but more so over its impact on exporters. Data suggests big onshore banks have accumulated large dollar positions but could not find an exit for dollar liquidity so further outflows are being encouraged.

Let's move to the longer term. Dual circulation was the catchphrase for last year as China seeks to boost domestic demand. If anything, the data shows rebalancing is going into reverse as investment growth continues to outpace consumption. Is rebalancing a lost cause and we will see leverage start to rise again to dangerous levels, which would undo all the work between 2016 and 2018?

- Last year there was a strong increase in credit growth from 10% to 13.5%, but the PBoC has made it clear that last year's pickup was a one-off and not a persistent policy.
- Growth in credit will be in line with nominal GDP so leverage growth will be flat, likely to be around 10%-11% annualized – in line with nominal GDP growth. This is very similar to what happened in 2009/2010. What will happen in 2022 is a bigger question since if China reaches a new normal for growth of 5-6%, then how much will credit growth decelerate.
- There is a rebalancing from investment driven economies to consumption driven but it is no longer the priority. Corresponding targets, such as the service to GDP ratio, were dropped because the importance of manufacturing is growing out of necessity.
- Maintaining a large manufacturing sector is important for growth and for now there is no desire to increase the household share of GDP. The trade dispute with the US in recent years has fundamentally changed China's growth strategy. This will be disinflationary, especially for certain global sectors such as microchips as China invests massively in manufacturing capabilities in this sector: a similar situation occurred with solar panels in the previous decade.

While innovation is always welcome, Guo Shuqing has talked about the 'financialization' of the economy and it seems clear that there are huge regulatory gaps which could lead to financial stability problems and misallocation of capital. How do regulators strike a balance between maintaining financial stability and harnessing talent?

- Chinese financial reform happened much faster than expected, paving the way for China to lead FinTech globally.
- Technological innovation generally is welcomed though the scrutiny on fintech companies will only continue there are valid technical arguments for and against tighter regulation, but the wider context of decision-making is equally important.

One area PBoC is leading is central bank digital currencies. What are your views on digital currency and how will it take off? Particularly, will cross border usage start to take off, especially after the winter Olympics?

- China will introduce eRMB via a wallet on a smart phone. However, the dilemma is if people feel the eRMB is superior to bank deposits they will move all of their deposits to the electronic wallet, causing commercial bank balance sheets to shrink and central bank balance sheets to grow.
- PBoC wants eRMB to replace cash and a portion of bank deposits but its intention is not to overtake the entire banking system.

China's 2021 census will be released soon and I'm sure almost every single data point and conclusion will make the leadership and economic planners very nervous. Even the 14th five-year plan sounded very downbeat on demographics and talked more about harnessing the elderly rather than boosting the birth rate. Is it now fully accepted that China will grow old before it grows rich and what are the implications for long-term growth targets?

- Surprisingly, the urgency of demographics was not strong in the five-year plan. China still has a birth control policy of 2 child maximum. Like many countries in East Asia, the lack of ambition by the government to address falling birth rates is a puzzle. For example, recent discussions during the National People's Congress to fully lift birth restrictions in China's Northeast region, which has seen outright population contraction for several years, are happening a decade too late.
- Without drastic action, China's population will likely peak in the next five years and make the aforementioned 15-year targets challenging to realize.

What is the single positive and negative foreign investors are missing?

- Investors are not asking questions regarding the banking system or debt.
- The shift from economic fundamentals to foreign policies such as geopolitical issues in Hong Kong, Taiwan and the like may be overhyped in the short term. Despite diplomats being very hawkish, no one wants to have a war.

What are some upside/downside surprises in terms of China and US relations?

- Vaccines and the reopen of consulates
- Trade war, tariffs, export control and sanctions related to Hong Kong, all other geopolitics, etc. will only intensify. The Chinese strategy is to compartmentalize.

Digital RMB and goals for short term and longer term for the CNY internationalization. Can this become a new tether to crypto markets? How should we think about this against the USD?

- Unlike anonymous crypto currencies, Chinese eRMBs will be exposed to PBoC in real time.
- In terms of internationalization, we need to go back to the fundamental question: is China ready for a more relaxed capital account?

What carrots will the Chinese offer Germany, before and after the September elections, to encourage the Germans to continue to maintain sympathy to China's side in Sino American disputes?

- Tesla invested into a Gigafactory in Shanghai – China doesn't have an investment agreement with the US, but Tesla still built a factory. It is more so whether the Chinese government wants to support the project. China will offer some conditions to German companies (BMW, Mercedes, VW) to make sure they have fully owned Chinese venture.

LATAM CFO Panel: A New Paradigm

Panelists:

Didier Mena Campos, Chief Financial Officer, Santander

Walter Bayly, Chief Executive Officer, Credicorp Ltd.

Jose Acosta, Chief Financial Officer, Bancolombia

Bruno Constantino, Chief Financial Officer, XP Invetimentos

Moderator:

Daniel Tenengauzer, Head of Markets Strategy, BNY Mellon

Macro views

Brazil:

- Brazil is lagging in vaccination. Otherwise, it's on the right trend in terms of getting people vaccinated and hopefully returning to a new normal. Before the pandemic, many analysts expected a drop of 7% in GDP. Monetary and fiscal stimulus helped to mitigate the burden of this crisis. In terms of macro environment, interest rates have begun to rise to a single digit rate. Positive about Brazil macro outlook, although need the vaccination rate to be faster.

Peru:

- Peru's economy is generally small and tied to demand for commodities. When the world buys commodities, Peru does well. Thus, the global backdrop is pretty good.
- In order to get interest rates back to a normal place they have been dealing with a flat yield curve – practically 0% interest rates. This transition will have a short-term disruption—some pain. Confidence that the Fed, Peru CB, and key regulators of the world will smooth the transition. Long dated Fixed Income and EM will suffer in the front end.
- Domestic: Peru has been slow to vaccinate, but it originally had one of the strictest lockdowns which proved to be unsuccessful. It ended up damaging the economy and still caused a health crisis—double downside. Today, the majority of the economy is participating at full capacity. The two industries still effected by Covid—tourism and hospitality.
- Elections on April 11th: Polls have changed quite rapidly in the past week—a tremendous amount of the population is still undecided. Experience in the past, politicians need to capture the middle to get elected. The world is becoming more polarized and that will likely happen in the second round. Not a lot of expectations at the moment. Political stability has never been the norm in this country. Rather stability has come from the central bank and Finance Ministry.

Mexico:

- Economic developments: Remittances have stayed supportive throughout the pandemic. Appears to be going through the next big wave of tourism.
- Haven't made a full recovery to pre-pandemic activity. That being said, this year Mexico will be leading the recovery for LATAM. This is correlated to strong fiscal stimulus from the US. Mexico had one of the most modest stimulus packages. Remittance is associated with the fiscal package that the US put forward. A lot of Mexicans living in the US have benefited from that. It has been positive being neighbors to the US from a health and economic perspective. In Mexico, vaccination started slow, but picking up-- 9mio doses administered, but only 1mio fully vaccinated. Daily pace is 300K doses administered. Goal is to get to 80mio by end of May—need to multiple by 5 times the doses administered recently—ambitious target.
- Medium/Long term challenges: Uncertainties associated with investment. Investment levels are similar to those 8-9 year ago. The different policies that the current administration is putting forward also adds more uncertainty. It will be difficult to attract foreign and domestic investments. Also, seeing significant contraction that is impacting the banking sector. Loan demand from corporates is declining and is expected to continue.
- Elections: Congress and 15 government estates that are up for renewing governors. Recent recognition over challenges the administration is facing. Everybody surprised by strong support that Morena got in 2020 elections. Not clear if they have been good at executing what they promised.

- Interest rates: Reached a bottom at 4%, still some room for slight decrease, but certain headwinds in terms of inflation that prove to be temporary. Central bank has been prudent in terms of monetary policy.

Colombia:

- Government conducted pandemic in an orderly way. Vaccination pace is low, but optimistic about the next couple of weeks.
- Expecting GDP growth of 4/5%, but recovery will take place in second half of the year. This quarter is still seeing flat financial demand. Predict a large recovery in 2022/23. This year is a transition year. GDP will recover because sectors impacted (construction, mining, tourism) weightings were high, but will bounce back in 2022.
- Inflation is under control. Currently 1.6%, expecting 2.5% therefore not expecting change in interest rates.
- Concerns: 1) Tax reforms. Taxation is extremely low in Colombia. Government is trying to increase taxation and will see some challenges in terms of that. 2) Unemployment level—foreseeing 13% at end of the year. Colombia is usually around 10%, 13% is a real concern.

Digital Currencies

Brazil:

- The pace of digitalization accelerated very fast due to Covid. Brazil is already a digital country in the sense that everyone has mobile. What we learned from the crisis is to use it even more.
- Brazil is probably third largest in the world in terms of entrepreneurship even when interest rates were high. Now with low interest rates (in the single digits), Brazil is welcoming even more entrepreneurs to disrupt several markets. Digitalization is key for that to happen. Digitalization allows you to diminish margin of cost.
- Seeing the transformation in Brazil and all of LATAM—Covid is a catalyst for digitalization and has impacted business positively.

Peru:

- What are the challenges of running a financial institution in a country like Peru and going through digital transformation? Amazon decided to lower its profit by 25% to invest. The realities of how incumbent financial institutions are run are different from those that are naturally born digital.
- Started digitalization process 6 years ago. The strategy they followed was different. Squeeze effectiveness in order to fund the investments required to build this new area. Trying to develop their own internal disruptor. Transform existing institution and build own internal disruptor. Have FX disruptor, insurance, etc.
- During this short period of Covid we have seen levels of digitalization advance—have decided to accelerate pace of investments.

Mexico:

- In the banking sector, the pandemic has been a catalyst to digitalization. There has been a significant increase in digital clients and channels. Clients that already have a bank account in the Mexican banking system are leveraging more on the utilization. We are still not seeing a contraction in terms of physical branches—they are still relevant in Mexican economy due to use of cash. 90% of transactions are done in cash, which has to do with the lack of benefits that the client perceives for not using cash. Also has to do with infrastructure. Different newcomers are gaining significant relevance in terms of digital infrastructure. It also has to do with trust—transparency. Connectivity also needs to be considered—if you're in a "blind spot" you need to pay with cash. There is a general distrust due to transparency, reliability, connectivity.
- Financial inclusive initiative—for clients who have the patience and education to use digital channels. Once introduced to digitalization they love it, but not at the pace it needs to be at.

Colombia:

- Began digitalization process 2-3 years ago. Colombia has a spread-out population so need to be more creative. Today processing only 3% of transactions from physical branch the rest of transactions are being processed digitally. Began the year with 10mio clients now have 14mio. It is supposed to help us in transition period—low cost, faster, more secure. A lot of money has been allocated to digitization.

- Key to digitalization is information. Half million of QRs—best way to reach data and understand clients.

Are politics the same or worse as the pandemic plays out in LATAM - and how do you think this changes finance in the years ahead? Does the uneven recovery mean more taxes, more digital solutions?

Brazil:

- Brazil was on a trend of reformation—this needs to continue. Because of the pandemic, the government has needed to help the less fortunate by giving more money. Now, the good and bad news is that the government doesn't have any more money. The pressure for reforming the country is even higher because of the debt from the pandemic. It is important to focus on inflation and what it means for the country.

Mexico:

- The impact has been significant. Whether good or bad we'll see over the next few years. The pandemic hits in a moment where Mexico is going through change in terms of policies. The current administration is right in terms of identifying what is wrong but might not be going about it in the right way-- challenges in the short term are being created. On one hand, you have people who want to keep trusting the current administration. Others think enough is enough. The election in June will be a good thermometer on how people are thinking.

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