The USD/RMB has held steady since June 2008 and the lack of clear catalysts for a stronger RMB suggests status quo is likely to remain for now. Among other factors, substantial dollar holdings in China's forex reserves and a loose monetary policy stance should prevent RMB from firming significantly near term. We maintain our USD/RMB forecast for end 2009 at 6.82; and at 6.77 for end-2010, from current level of around 6.828.

PBoC's monetary policy stance is expected to stay loose at least until mid-2010, as the shape and speed of current recovery is still uncertain. Nevertheless, "fine tuning" around the fringes is taking place in view of concerns of asset price bubbles, but that should not be mistaken as a shift in policy stance. We look for China's key 1Y lending rate to hold steady at least through mid-2010 at 5.31%, and then to 5.85% by end-2010 as PBoC begins its rate hike cycle.

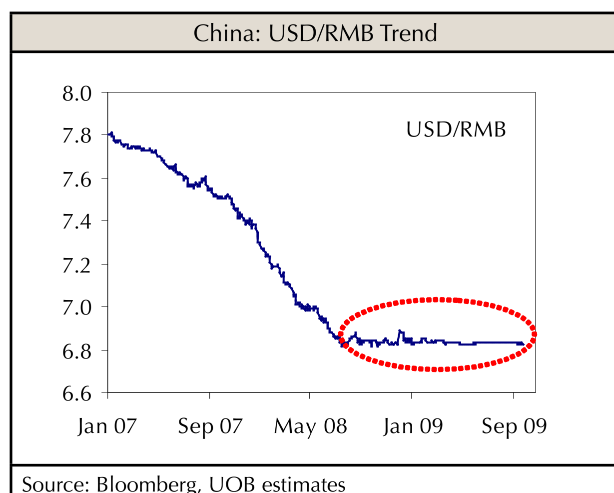
China's growth target of 8% is attainable this year, as statistically it is feasible on the back of a 7.1% expansion in 1H09. More importantly, the infusion of fiscal stimulus has managed to overcome the exports shortfall, which is one of the worst in Asia. Putting aside the debate on "quality" of the growth, we expect China's headline GDP growth to rise above 8% on average in the second half of 2009, after expanding 7% in the first half. Our full year forecast for China' headline growth is 8% for 2009, and then rising further to 8.5% in 2010.

RMB: Springing Back to Action?

Since June 2008, the USD/RMB has held steady, largely confined within a narrow range at 6.82-6.84, despite continued weakness in the broad dollar (DXY) especially since 2Q09 when risk appetite returned. However the acceleration of USD weakness near end-3Q09 saw USD/RMB hovering just below the 6.83 level. At the same time, the non-deliverable forward (NDF) market is beginning to price in a slightly larger appreciation of the RMB in mid-September, at about 1.5% over the 12 months, almost doubling the average expectation of 0.7% during the lull period in July-August.

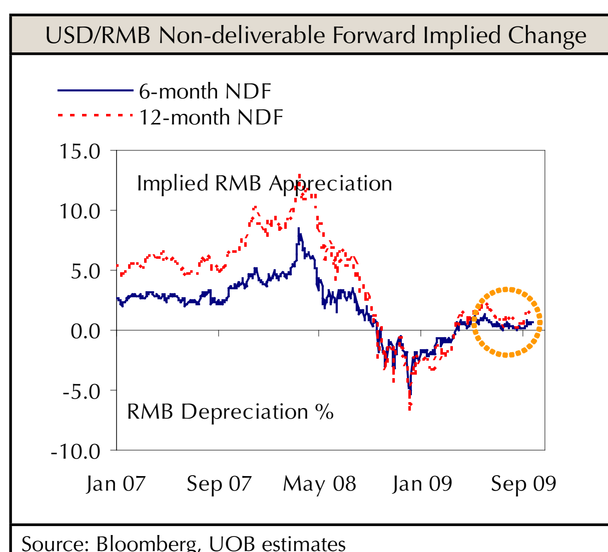
While the USD/RMB has apparently sprung back into action in recent weeks, these moves are on the back of even further USD weakness, amidst expectations of a global economic recovery and continued appetite for risk. Nevertheless at this juncture, we continue to expect only limited RMB appreciation into 2010.

China: USD/RMB Trend



Source: Bloomberg, UOB estimates

USD/RMB Non-deliverable Forward Implied Change



Source: Bloomberg, UOB estimates

The Factors Below Support the Case for a Steady RMB For Now:

1) China's forex reserves [about 60% in USD assets] will suffer revaluation losses if USD declines substantially. Our calculations show that these marked-to-market losses in the past two years have typically overwhelmed incomes generated from the forex assets. Out of China's US$2.1tn forex reserves assets, US govt debts alone ac-

count for US$800bn or more than 1/3. This means that sharp declines in US bond prices and/or the USD would have a significant negative impact on the portfolio.

2) China's efforts to promote the use of RMB to settle import/export trade transactions (started in July in key cities in China, HK/Macau, and ASEAN and on track to expand further). However, firms would accelerate use of RMB only if its value is stable/predictable compared to existing arrangement.

3) Exports have declined in double digits so far in 2009 and are set to contract by about 20% for the full year even if the pace were to moderate in 4Q, and a stable currency would mitigate losses for exporters.

4) A stable/moderate appreciation of the RMB is consistent with the current loose monetary policy stance in China, which is unlikely to see an interest rate increase until second half of 2010. As it stands, interest rate differential is already in favour of RMB vs. USD as the Fed funds rate remains at near zero. Further widening of the rate spread would add even further appreciation pressure on the RMB.

With the lack of catalyst for any substantial move down, the USD/RMB pair is likely to keep its stable footing at least through mid-2010. We maintain our USD/RMB forecast for end 2009 at 6.82; and at 6.77 for end-2010, from current level of around 6.828.

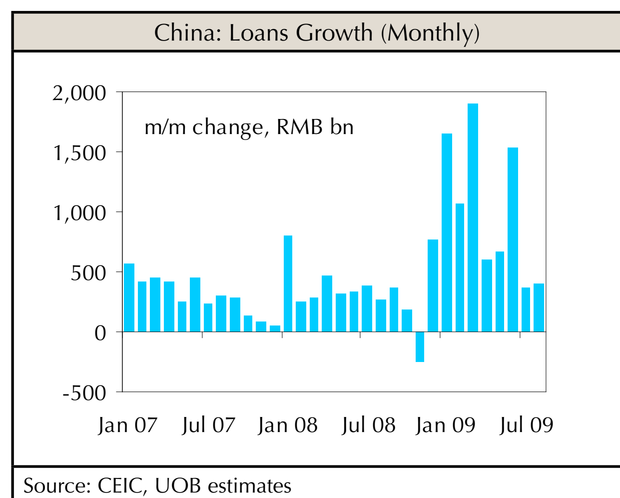
However, there are risk factors which could upset our forecasts for a steady RMB. In particular, there are significant pressures in recent months for PBoC to tighten policy to curtail domestic liquidity as property and equity prices surged. Foreign capital inflows have also accelerated, in anticipation of rising asset prices (and future gains in RMB). Additionally, policy change (e.g. RMB gains) could be abrupt if external demand/conditions recover faster than we anticipated. Among the obvious channels that PBoC could tighten would be via exchange rate and/or policy interest rates, which we expect are now heading towards the direction of "exit strategy".

Monetary Policy: "Fine Tuning" A Loose Policy

As China's economy, along with Asia and global economies, stabilizes, prospects of central bank tightening begin to emerge. Worries of credit quality, rising equity and property prices ("bubbles"), possibility of increased excess capacity and other concerns have begun to come into the picture.

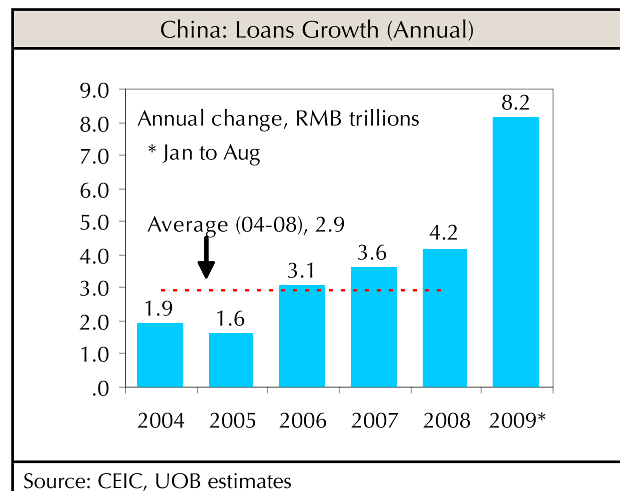
On the back of the RMB8.2tn new loans issued in Jan-Aug period (2008: RMB4.2tn), it is apparent that China is rethinking those emergency monetary policy measures that came into force when global credit markets went into a standstill post-Lehman. The scale of China's credit creation appears to be excessive, which more than doubles the amount granted in 2008, and is nearly 3 times above the average in 2004-08, a period that saw the economy expanding at nearly 11% annually Assuming new loans granted slow to RMB200bn per month in the remaining four months of 2009, that would still mean RMB9tn new loans this year.

China: Loans Growth (Monthly)



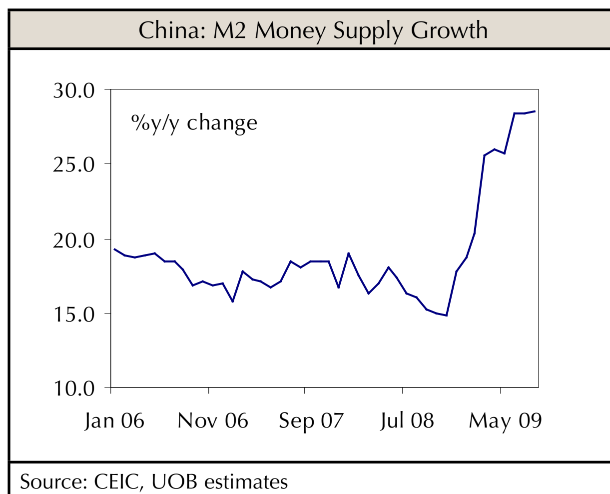
Source: CEIC, UOB estimates

China: Loans Growth (Annual)



Source: CEIC, UOB estimates

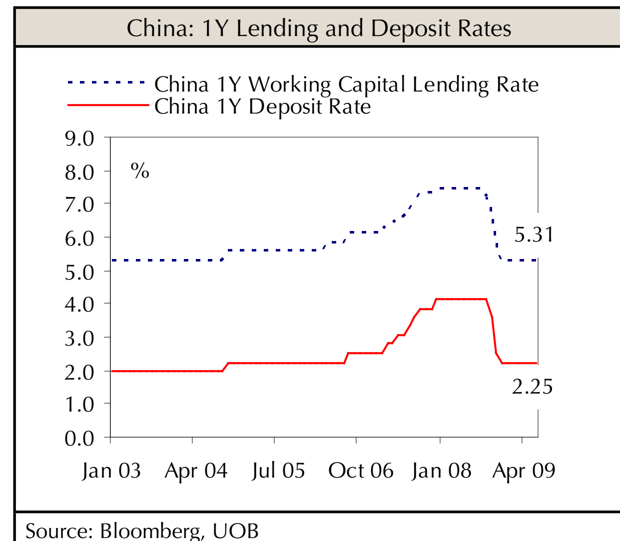
Another indication that is a concern is that the M2 money supply, which has been expanding at a record 20-28%y/y each month for the last 6 months, from a monthly average of 18% during those years of strong growth in 2004-2008. Based on historical trend, a more reasonable growth rate for the M2 should be confined within 20-25% at most, and a slower loans growth would prob-



ably achieve that target.

With the pace of global recovery still uncertain, we do not expect an abrupt shift of the loose policy measures in the immediate future. Nevertheless, a prelude toward "exit strategy" is already underway, going by announcements of more stringent measures/higher standards being applied especially on bank sector, e.g. raising credit standards, higher requirements for banks capital; PBoC's bill issuance to drain excess liquidity out of the system, among other measures. According to Bloomberg News, China was apparently working on tightening banks' capital requirements. The net effect of such policy is that credit growth would be curbed especially at smaller banks. PBoC has also been using bill issuance to drain liquidity, with the 1Y bill issuance returning in early July this year, after an unusual absence of almost 8 months since early Nov 2008, as the PBoC has been conducting regular (at least monthly) operations in recent years. The return of bill issuance suggests that the PBoC is concerned about the flush liquidity condition.

These activities, however, should be seen in the context of "fine tuning" or adjustments within the existing accommodative policy stance. We are unlikely to see - at least over the next 6 months or so - outright tightening, i.e. interest rate/reserve requirement ratio hikes or cut in loans. This is especially the case when global economic backdrop within the next year remains unclear and central banks tend to err on the safe side before reversing policy stance. Nevertheless, we expect by mid-2010 a shift in policy stance or a gradual withdrawal of the loose monetary, i.e. "exit strategy", not just in China but across the world as well (our focus article "Monetary Policy Trajectory in Asia" discusses in further detail the likely timetable of Asian central banks' next move in 2010). China's key 1Y lending rate should hold steady at least through mid-2010 at 5.31%, and then to 5.85% by end-2010 as PBoC begins its hikes.



Macro Backdrop: 8% Growth Target on Track for 2009

China's macro backdrop remains positive, as fiscal stimulus plans manage to offset the declines in external demand, while an accommodative monetary policy stance fuels credit expansion. This is a similar response that most other Asian and G7 governments have undertaken to contain the current global economic recession.

As indicated in data releases so far, the policy response should be considered effective and successful. China's exports have declined 22%y/y in the first 8 months of 2009, among the worst performers in Asia. However, investment spending [which accounts for about 40% of China's economy] fills in the gap with fixed asset investment (FAI) rising 33% so far in 2009, on the back of the 2-year RMB4 trillion fiscal stimulus plan.

In particular, growth drivers in China came in the form government stimulus plan, as the topline growth in investment spending was dominated by infrastructure-related investments. For instance, transport and environment-related investment has been rising at a 50-60%y/y pace in the first 8 months of the year, while construction sector investment grew at around 47%, well above the headline growth rate for FAI. While state dominance has helped China to pull through this difficult period, this means that "quality" (i.e. external demand) has to return to keep growth on a more equal footing, especially when

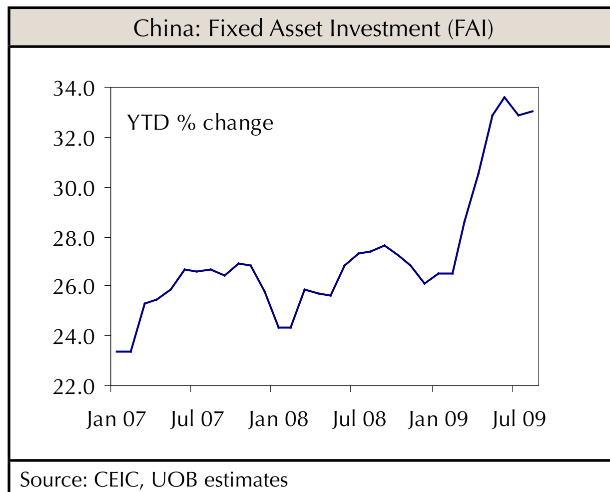
▪ China

fiscal stimulus exits the scene.

Putting aside the debate on the "quality" of the current growth profile, we expect China's headline GDP growth to rise above 8% on average in the second half of 2009, after expanding 7.1% in the first half. Our full year forecast for China' headline growth is 8% for 2009, and then rising further to 8.5% in 2010. Note also that these figures are still far below the average of 11% p.a. attained during the 2003-2008 period, but those days are unlikely to return in the next few years. Nevertheless, these growth rates would still be the world's fastest this year and next.

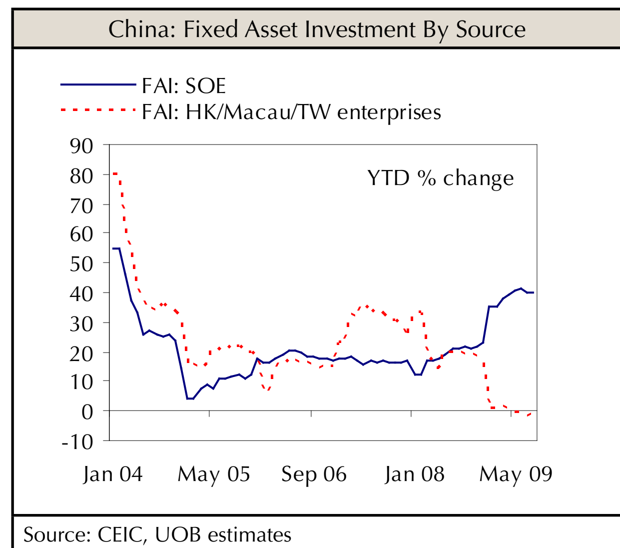
Key risks in the next 6-12 months: 1) the timing and extent of China's monetary policy tightening remains uncertain, which has been keeping China's equity prices on edge; 2) speed and extent of global economic/external demand recovery is ; 3) Inflationary pressures, if excessive, could result in pre-emptive tightening.

China: Fixed Asset Investment (FAI)



Source: CEIC, UOB estimates

China: Fixed Asset Investment By Source



Source: CEIC, UOB estimates

UOB Economics Projections	2007	2008	2009F	2010F
GDP	13.0	9.0	8.0	8.5
CPI (average, y/y)	4.8	6.0	-0.8	2.2
Current Account (% of GDP)	11.2	7.8	5.5	4.1
Fiscal Balance (% of GDP)	0.7	-0.4	-3.0	-2.6