# China

| UOB Economics Projections | 2007 | 2008 | 2009F | 2010F |
|---|---|---|---|---|
| GDP | 13.0 | 9.0 | 8.0 | 8.5 |
| CPI (average, y/y) | 4.8 | 6.0 | -0.7 | 3.1 |
| Current account (% of GDP) | 11.2 | 7.8 | 5.5 | 4.0 |
| Fiscal balance (% of GDP) | 0.7 | -0.4 | -3.0 | -2.6 |

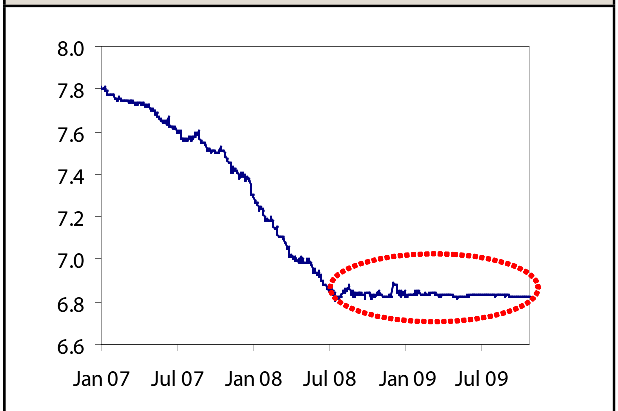
- *The scenario of a flat USD/RMB is likely to be extended into the next 1-2 quarters in 2010, given that China is in a situation of a "dollar trap" with its large forex reserve holdings. However, we should expect some gradual firming of the RMB starting from 2H2010 to coincide with normalization of PBoC policy as part of its "exit strategy", with the pair moving to 6.77 by end-2010, implying less than 1% gain for the year.*
- *PBoC's monetary policy stance is expected to stay loose at least until mid-2010 but "fine tuning" has already begun, with regulation changes in property market. This suggests that banks' reserve requirements are likely to be the first to move up, possibly in early 2Q10, and then followed by normal policy rate hikes starting from 3Q10. We look for China's key 1Y lending rate to hold steady through mid-2010 at 5.31%, and then to 5.85% by end-2010.*
- *Recent data releases reaffirm China's growth trajectory remaining intact, and we expect a headline real GDP expansion of 8.5% in 2010, from about 8% in 2009. Consumer prices look set to head higher on a combination of lower base and firmer demand but should remain manageable in the 3% range and least of central bank's worries. Of greater concerns is asset price inflation, especially in the property sector. Further measures are likely to be in place in 2010 to dampen property price increase, though the effect remains to be seen.*

## RMB : Staying Flat Ahead

With the USD/RMB remaining in a virtual peg mode since mid-2008, we continue to expect the pair staying in a holding patter at least in the next 3-6 months. This is evident from Chinese leadership rebuffing demand for a firmer RMB from the likes of US Pres Obama and senior EU leaders during their respective visits to China in November. On the spot market and daily fixings, the USD/RMB pair has so far been stuck at the 6.827 level, although the nondeliverable forward (NDF) market has been pricing in around 3% appreciation for the RMB over the next 12 months.

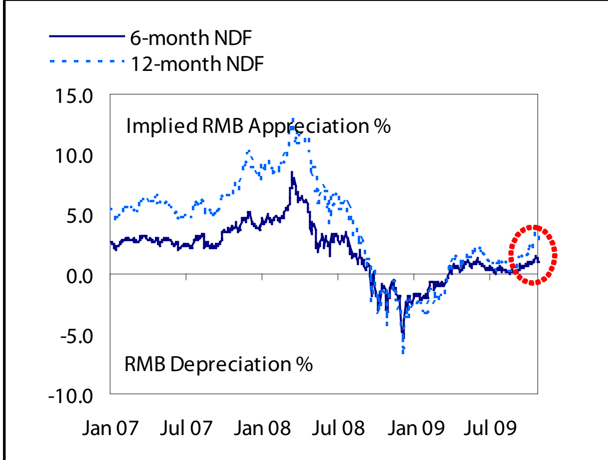
Note that NDF prices are typically volatile and the predictive ability has not been stellar. For instance, the 12-month NDF market back in March 2008 was pricing in nearly 13% gain for the RMB, just months before the RMB went into a virtual peg against the USD. The expectations subsequently fell

USD/RMB Trend




Source: Bloomberg, UOB Estimates

USD/RMB Non-deliverable Forward Implied Change




Source: Bloomberg, UOB Estimates

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into negative 7% as risk aversion peaked at end-2008/ early 2009 when the global financial crisis deepened. This means that caution is needed when interpreting prices/ expectations from NDF markets which are subject to similar sentiment that is prevalent in other financial market prices.

Given ongoing official statements and media reports, China's leaders are clearly cognizant of the impact of China's loose monetary policy (and RMB peg) on domestic asset prices. The situation is further compounded by RMB's de facto peg to the USD, which means China is also adopting/ importing US Fed's loose monetary policy. To offset the effect of a stimulative monetary policy on domestic asset prices, one course of action is to let external sector shoulder the weight (via a stronger local currency). At this point China is still reluctant to strengthen the RMB, and we believe there are more reasons beside the traditional "weak currency is necessary for exports / labour market recovery" argument. Some of the likely motivations and considerations are as follows:

1) China's forex reserves [about 60% in USD assets] would suffer revaluation losses if USD declines substantially. Our calculations show that these marked-to-market losses in the past two years (as RMB strengthened) have typically overwhelmed incomes generated from the reserve assets. Out of China's US$2.3tn forex reserves assets, US govt debts alone account for US$800bn or more than 1/3. This means that sharp declines in US bond prices and/or the USD value would have a significant negative impact on China's external wealth.

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 the currency value is stable/predictable compared to existing arrangement.

3) 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 differential would add even further appreciation pressure on the RMB.

4) A downward move in USD/RMB especially in the current global market backdrop could be interpreted negatively and potentially spark a sharp selloff of an already weak USD, thereby destabilizing global financial markets.

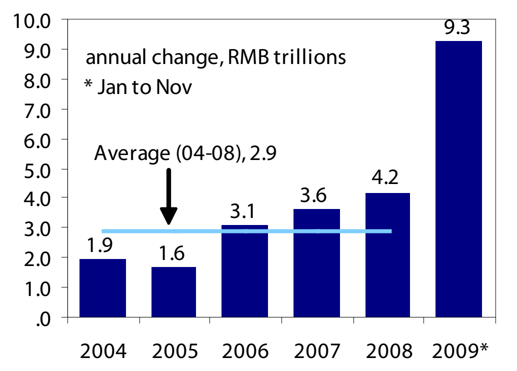
5) The experience of the 1985 Plaza Accord on the Japanese yen (which saw USD/JPY falling more than 40% to 152.50 by Feb 1987 when the Louvre Accord was reached), and the subsequent boom/bust in Japan's asset prices and recession/deflationary spiral, is another key factor why China is proceeding cautiously despite repeated calls that the RMB is overvalued.

In other words, the above factors suggest that China is unlikely - at least in the next 3-6 months or even longer - to engineer any substantial RMB appreciation against the USD given this situation of a "dollar trap". However, we should expect some gradual firming of the RMB starting from 2H2010 to coincide with normalization of PBoC policy as part of its "exit strategy". As such, we continue to see USD/RMB to remain steady in the next 3-6 months, with the pair hovering at 6.81 by mid-2010 and then to 6.77 by end-2010, implying less than 1% gain for the year.

### Monetary Policy: Policy Risks Ahead

As mentioned in our previous quarterly, China was rethinking of its extra-loose monetary policy measures just as economic growth is back on track and amidst signs of price bubbles in domestic asset markets, on the back of strong credit growth (Year-to-November: +RMB9.3tn new loans vs. +RMB4.2tn in 2008).

Loans Growth (Annual)




Source: CEIC, UOB Estimates

However, we expect that the overall monetary policy framework to remain largely at its current loose bias at least over the next 3-6 months – along with a steady USD/RMB stance. The status quo is reinforced by the latest Annual Economic Work Conference which sets the tone for policy in the coming year. At the conclusion of the Conference recently (on 7 Dec 2009), it reiterated the need of an

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"adequately loose" monetary policy as well as "active" fiscal stimulus policy for the coming year, which is interpreted as maintaining the policy status quo. Bloomberg reported in early Dec that China's banking regulator would be setting a loan growth target of RMB7-8tn for 2010. While this loan target would be slower than the hectic pace seen in 2009 – signaling a "tighter" stance – it is still about twice as large as the RMB3-4tn range annual increase see during the 2006-2008 period.

However, post-Conference, the government has released further administrative measures to deal with speculation in the property. We expect more of administrative measures to feature in the next 3-6 months as a way to curtail excess liquidity.

In the latest announcement on 8 Dec, the Chinese government will be imposing a sales tax on homes sold within five years of their purchase, increasing the time period covered from two years. China had reduced the penalty period of the tax to two years from five in January this year as a way to loosen asset markets.

These recent actions suggest two planks for the coming six months: 1) overall loose policy stance is maintained, and 2) tighter regulation via administrative measures will be increasingly introduced to curb speculation. As such on the interest rate front, we see PBoC maintaining the 1Y lending rate at 5.31% through to mid-2010, before hiking slightly to 5.85% by end-2010. However, the banks' required reserve ratio (RRR) is likely to be raised as part of its administrative measures, and we see the ratio to start moving up from as early as 2Q10 after the annual National Peoples Congress (NPC) meetings in March 2010. All in, we see the RRR to be raised six times in 2010, from the current 15.50% to 18.50% by end-2010.

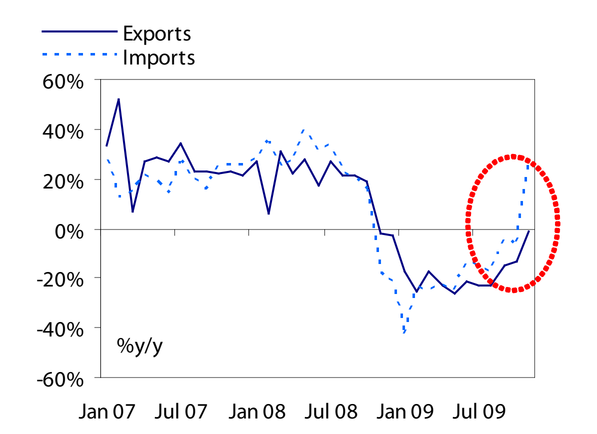
### Macro Backdrop: Inflation Turning Positive but at a Mild Pace

We expect economic activities in China to remain brisk in 2010, as stimulative fiscal policy measures spill over into the new year, while the PBoC should remain accommodative in the first half of the year (as mentioned in comments above). In addition, the much weaker base in the first half of 2009 will give a very strong statistical boost to various data coming out in early 2010. We continue to see China's GDP growth to be able to maintain at around the 8.5% in 2010, after expanding about 8.0% in 2009.

This is reinforced by data releases in recent months, which show a pick up in activities across the board. On the external front, China's exports improved sharply to -1.2%y/y in Nov vs. -13.8%y/y in Oct, while imports turned in its first positive reading at +26.7%y/y from -6.4%y/y in Oct, the first gain in 13 months. Industrial production also surprised on the upside in Nov, coming in 19.2%y/y from 16.1% in Oct, as infrastructure spending benefited heavy industry output (which normally accounts for more than 2/3 of industrial output) even though light industry output is relatively subdued.

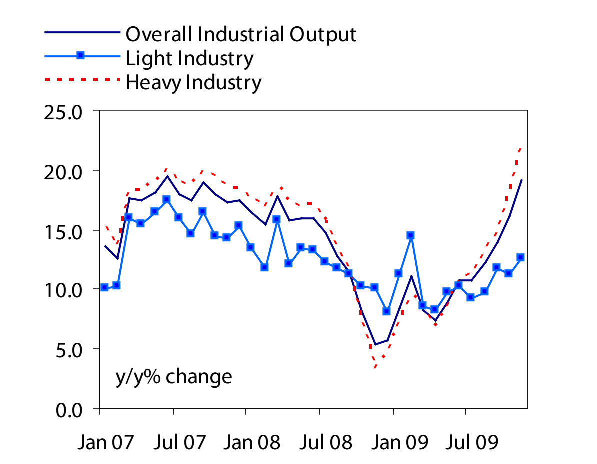
The one area of increased concern is the effect of loose policy on inflation. Consumer prices returned to positive 0.6%y/y in Nov, after 9 months of y/y declines, as producer price index (PPI) gradually show smaller declines due to improvements in prices of heavy industry products.

External Trade




Source: CEIC, UOB Estimates

Industrial Output




Source: CEIC, UOB Estimates

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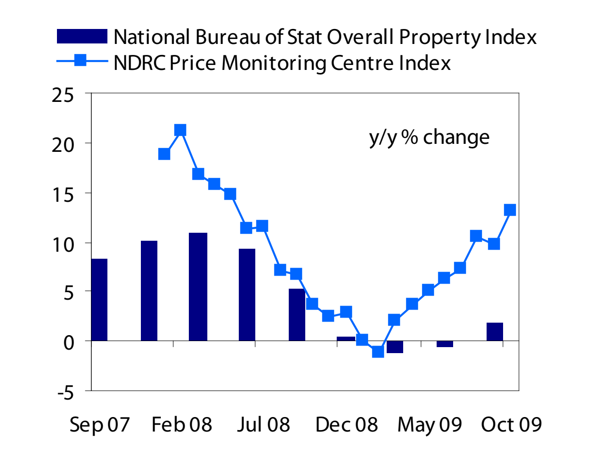
Property Prices




Source: CEIC, UOB Estimates

One should note that there are two distinct sets of prices that need to be addressed: consumer prices and the broader "asset prices".

China's consumer prices have remained benign through most part of 2009, - as the effect of global financial crisis hit - which was subsequently offset by various government measures. One main factor that has been suppressing consumer prices is the moderate pace of increase in consumer spending (proxied via the monthly retail sales, which rose 15.8%y/y in Nov, vs. 16.2% in Oct), as well as the compression in prices at factory gate (via the monthly producer price index, PPI) as a result of excess capacity worldwide. Although there are signs of prices for food and energy are beginning to rise on the back of cutting back in state subsidies, overall consumer price inflation should still remain relatively benign into 2010, which we project to average about 3% from about -0.7% in 2009. In the last bout of deflation in China, which lasted for 5 quarters ending in 2002, consumer prices rose about 1.2% in 2003 and then 3.9% in 2004, from -0.8% in 2002. Factoring in the loose policy stance in the current environment, it is reasonable to expect consumer prices accelerating in 2010 but would be capped somewhat given excess capacity conditions and that consumer spending has yet to rise in a meaningful way.

Relative to consumer prices, of greater complexity is the surge in asset prices (especially residential property) which may be a more difficult issue to deal with given the current policy environment. Based on data from National Bureau of Statistics (NBS), overall property prices rose about 1.5%y/y in 3Q09 after contracting about 0.8%y/y in 1H09. However, property prices in 36 cities monitored by National Development Reform Commission (NDRC) showed an average of 11%y/y gain in the Aug-Oct period, after rising steadily since March.

While it is debatable to the extent of property price increases due to lack of uniformity and clarity in data, a report published by the China Academy of Social Sciences (CASS) in November ("Annual Report on Development of Housing Market in China 2009-2010") estimated that stripping out speculative demand and considering only urbanization, income changes, population movements, employment opportunities and other fundamental factors, there is in fact an excess supply of residential property in 2009 in China's 35 major cities for the first time in 6 years, to the extent of 18.28%. In addition, CASS also noted that excess demand for housing has been declining since 2003 as supply was ramped up. However, CASS noted in a separate report released in early Dec ("Blue Book" on Economic Outlook) that housing affordability has declined substantially in China as average property prices rose to 8.3x of annual income in urban areas, compared to a normal or reasonable range of 6-7x, and that 85% of families (incl. urbanizing of rural segments) cannot afford to purchase their own shelters. Taken together, these two reports suggest that prices and the supply-demand dynamics appear to be out of sync in China. Added to the mix is that fiscal stimulus measures, urbanization, rising personal income, uneven tax structure, local governments' bias towards property development, and other factors also contribute to upward pressure in property prices. The Chinese government has already started to make its move on curbing property prices and further measures are likely to be in place in 2010, though their effect on deflating the price "bubble" remains to be seen. The next key event to watch is the annual National Peoples Congress meetings in March, which should see further debates and measures on curbing property price bubbles.