▪ China

UOB Economics Projections	2007	2008	2009F	2010F
GDP	13.0	9.0	6.5	8.3
CPI (average, y/y)	4.8	6.0	-1.7	0.2
Current account (% of GDP)	11.2	7.8	5.6	4.3
Fiscal balance (% of GDP)	0.7	-0.4	-3.1	-2.8

RMB remains steady against the USD despite continued volatile moves in the global currencies. We expect the RMB to stay flat as an appreciation bias could add further burden to exporters. In fact, the RMB is already appreciating on a trade-weighted basis. We see the USD/RMB to continue to range between 6.82-6.83 for now.

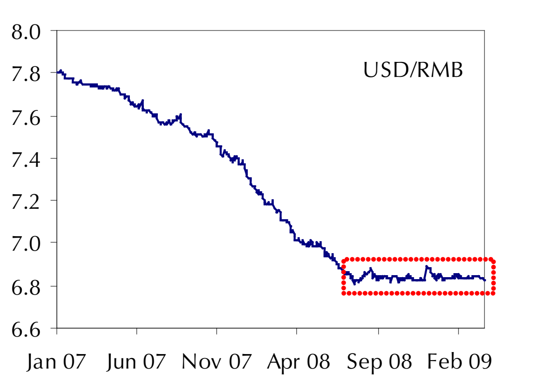
On the interest rate front, we are scaling back significantly our expectations of further cuts ahead. It is clear the preference is to ensure credit flows are not impeded and pricings are sufficient to ensure banks' profitability and incentives for savers. We are anticipating at most another 54bps cut this year to bring the 1Y benchmark lending rate to 4.77%.

Data from Jan-Feb show a mixed picture for economic outlook. Boosted by the large fiscal stimulus measures, domestic oriented data have stabilized, but these are offset by continued weakness in external-oriented data. The tussle between the two sets of data is still ongoing but we reiterate our 2009 GDP forecast of 6.5%.

Reiterating a Flat USD/RMB Outlook

USD/RMB actions over the past 6 months remain stagnant as the global financial crisis continues to wear on. The trading range fluctuated narrowly between 6.83-6.85 in the first 3 months of 2009, with negligible YTD change. In contrast, RMB gained nearly 7% against the USD in 2008.

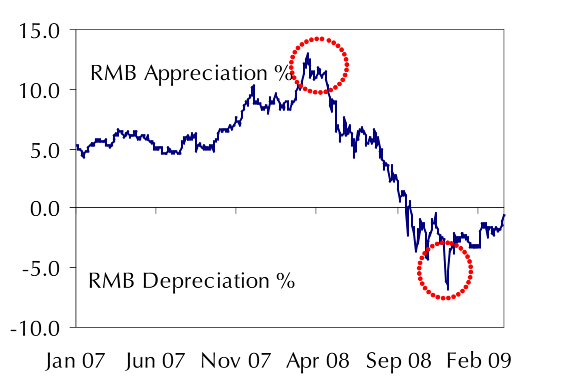
USD/RMB Exchange Rate



Source: Bloomberg; UOB Econ-Treasury estimates

However, the USD/RMB non-deliverable forward prices (NDF) saw more volatility over the past several months, as market participants had initially expected a significant depreciation for the RMB. Implied depreciation for the RMB against USD came to as much as 7% in late 2008, but has gradually been pared to around 1-3% depreciation for most part of early 1Q09. The expectation has again been reduced to sub-1% since USD weakness set in around 17 March when the US Fed announced its plans to purchase US Treasury as part of its Quantitative Easing program.

USD/RMB Non-deliverable Forward Implied Change



Source: Bloomberg; UOB Econ-Treasury estimates

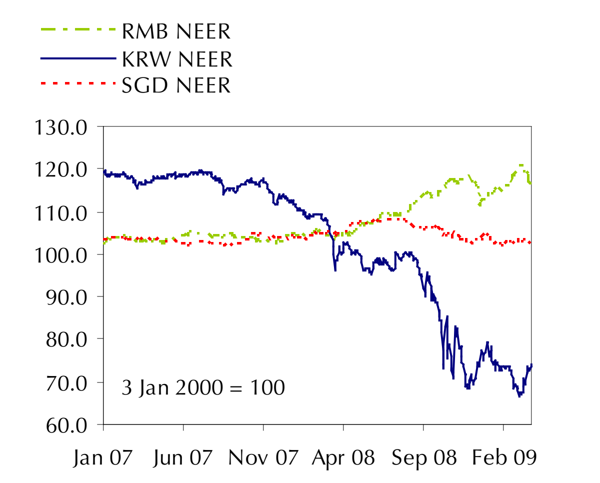
Recent comments by PBoC and US Treasury on the status of the USD as a reserve currency had further roiled the global currency market. As we had argued here before, the risk for the RMB to depreciate against the USD is relatively low in the current juncture.

1) A substantial RMB depreciation is needed to have any meaningful impact. With the build up of China's trade surpluses still large even as external demand has collapsed. China's Jan-Feb 09 average trade balance came in at US$22bn, 57% higher than same period in 2008, and slightly lower vs. the US$25bn monthly pace in 2008. To address this trade imbalance issue, an RMB depreciation in the order of at least 10-20% is needed to be meaningful. Therefore, judging from the July 2005 one-off revaluation experience and the subsequent "gradual appreciation" pace, the risk of a large depreciation for the RMB is relatively low.

2) RMB Still An Anchor of Stability in Asia. Just as it did during the 1997/98 Asian financial crisis, China has vowed to maintain a stable currency policy during the current global credit crisis. History suggests that China would carry out this policy of a steady RMB at this time of extreme uncertainty and volatility, thus providing a stabilizing factor for Asia. In contrast, a policy of RMB depreciation would be counterproductive as it could anger its Asian neighbours with such "beggar-thy-neighbour" stance and lead to a new round of competitive devaluations across the region.

3) Trade-weighted RMB Remains on Appreciation Path. Relating to the point on RMB's role as a stabilization factor, the trade-weighted RMB (RMB NEER) has appreciated about 4% YTD, having gained 7% in 2008,

Trade-weighted RMB (RMB NEER)



Source: Bloomberg; UOB Econ-Treasury estimates

as most Asian currencies retreated against the USD both on bilateral and trade-weighted basis. This is the biggest increase yet for the RMB NEER, which gained just 4% during the 2000-2007 period. Of note is that the trade-weighted RMB accelerated in 2H08 just as the USD strengthened, suggesting that the RMB appreciation path in general has remained intact, albeit on a trade-weighted basis. In other words, by holding a steady USD/RMB, China is in fact absorbing the shocks from the global financial crisis, allowing other Asian currencies room to depreciate against the USD.

4) External Trade A Demand, Not Pricing, Issue. Another argument that favors a weaker RMB is to boost trade competitiveness. However, the hit on China's (and Asia's as well) export market stems from a broad deleveraging of the financial system and the real economy, followed by the global recession. Therefore the issue is one of fundamental demand weakness, and not a pricing issue. As such, resorting to a currency devaluation will not be the solution, although it may help prop up some exporters at the margin.

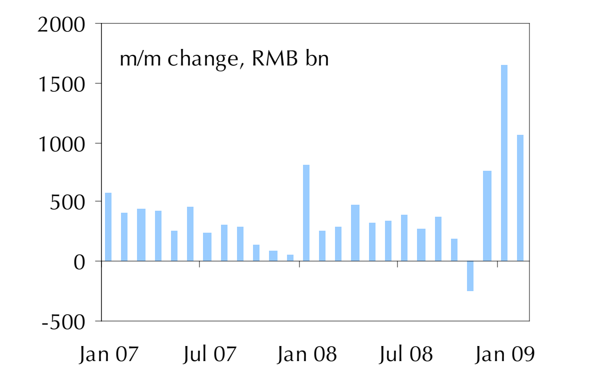
5) US Political Pressures Expected To Continue. US political pressures remain for a firmer RMB, as evidenced from US Treasury Secretary Geithner's remarks about "manipulation" at his confirmation hearings in Jan 2009. This suggests that the US government continues to pervious administrations' practice of seeking concession on the currency front from its trade partners to address the issue of US trade and current account "imbalances". The latest semiannual US Treasury report on currency policies, released on 10 Dec, noted that the RMB as still "undervalued" and repeated its calls for "greater appreciation against the USD in the near term." This means that a depreciation on the RMB is difficult to pull off without having a political repercussion.

While we do not see China engaging in a currency depreciation policy over the 12 months, we reiterate a stable and steady USD/RMB in the quarters ahead. We look for the pair to continue to hover within the 6.82-6.83 range towards end-2009.

In terms of interest rate policy, we are scaling back significantly our expectations of further cuts ahead. One factor is that officials have sounded cautious recently in terms of interest rate cut as signs of stability returned. Instead, the preference has been to increase lending activity and to ensure credit flows are not impeded in the system (as reflected in the strong loans growth figures in

Jan-Feb). It is quite clear that Chinese officials have recognized that the issue is not so much of pricing, but confidence of both borrowers and lenders. Another factor to consider is the preservation of lenders' margins and incentives for savers to continue saving. As such, we are anticipating at most another 54bps cut this year to bring the 1Y benchmark lending rate to 4.77%, as the current rate at 5.31% has hit historic low. For the 1Y deposit rate, we anticipate just 1 more reduction at 27bps to 1.98%. Another channel that is most likely to be tapped on is the reserve requirement ratio (RRR), which at current rate of 15.5%, is still some distance away from record low of 6% (1999-2003). We look for the RRR to move gradually towards 11% by end-2009.

China: Loans Growth



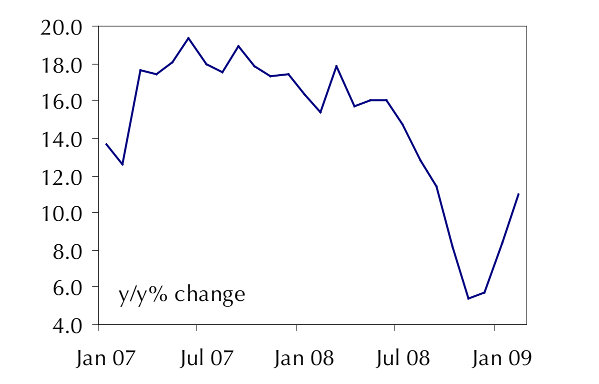
Source: CEIC; UOB Econ-Treasury estimates

A Tussle Between Domestic and External Factors

As the global recession deepens, recent Chinese data show a distinct divergence between those that could benefit from domestic stimulus measures, and those that are subject to external conditions.

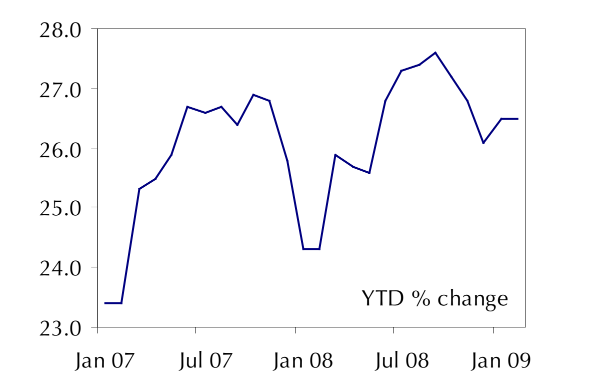
As such, domestic-oriented data such as loans growth, retail sales, fixed asset investment, among others, are showing signs of stability and even acceleration in some cases. External trade and production data continued to show weaknesses after external demand collapsed at the end of last year.

China: Industrial Output



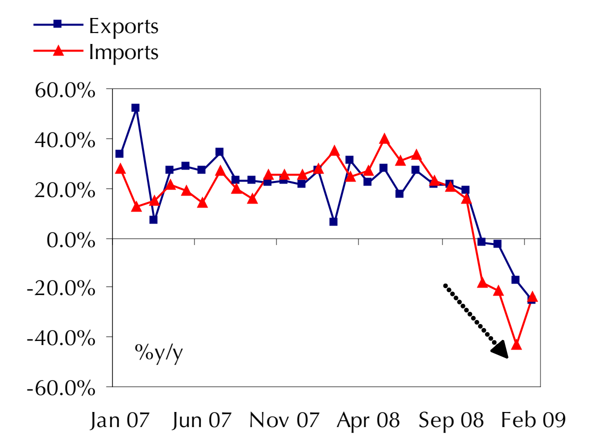
Source: CEIC; UOB Econ-Treasury estimates

China: Fixed Asset Investment



Source: CEIC; UOB Econ-Treasury estimates

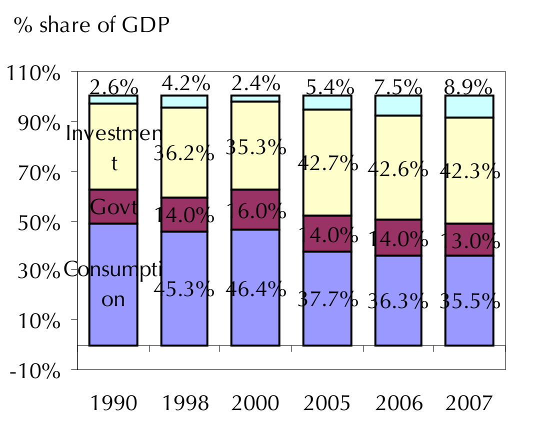
China: External Trade



Source: CEIC; UOB Econ-Treasury estimates

While leading indicators such as PMI indices have also rebounded from their November troughs, it is doubtful the 8% GDP growth target can be reached this year. One reason is that net exports contributions have grown significantly over the past few years as the external demand surged. However, with most major economies in deep recession in 2009 and possibly only weak recovery in 2010, this would keep the external demand component compressed (Both World Bank and IMF have projected the global economy to shrink by 1-2% in 2009). Note that net exports have risen to about 9% share of the China's GDP in 2007, significantly higher compared to the average of 2% in early 2000s. At the same time, domestic household spending has shrunk to record low of just 35% share of China's GDP in 2007, down from 46% share in 2000.

China: Share of GDP



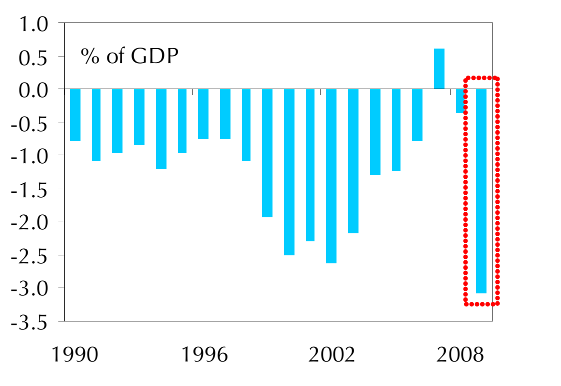
Source: CEIC; UOB Econ-Treasury estimates

However, it should be noted that fiscal stimulus plan announced in November last year is significant in terms of timing and size, and is responsible for stabilizing of these indicators. Even assuming that half of the RMB4tn are spent in 2009 and the remaining in 2010, that would still be nearly 7% of China's nominal GDP of 2008.

up to the free market system.

As increased fiscal spending will continue to course its way over this year and next, we are likely to see further improvements in domestic data in the months ahead. Indeed, infrastructure spending featured prominently (37% of total) in the November fiscal spending package and would certainly have the most significant impact on investment expenditure.

China: Fiscal Balance



Source: CEIC; UOB Econ-Treasury estimates

The question is whether the increased domestic spending is sufficient to offset the fallout from external demand. At this point, the official line is that the 8% growth target is still attainable this year. Given the size of the net export component (9% of GDP), both the collapse in external demand as well as China's increased import demand (as a result of a rise in domestic spending), that would be a key drag on top line growth. We continue to see that China is likely to come in slightly below official target, at 6.5% this year due to the sharp slowdown in 1H09, with a rebound back to around 8% growth in 2010.

China RMB4tn Stimulus Plans (Projected Sectoral Expenditures)		
Sectors/Items	RMB billions	% of total
Low cost housing	400.0	10.0%
Rural infrastructure (incl. irrigation, power, roads)	370.0	9.3%
Major infrastructure (incl. rail, airport, roads, utilities, power grids)	1,500.0	37.5%
Healthcare, education, cultural developments	150.0	3.8%
Environmental ("Green") projects (incl. reforestation, pollution cleanup)	210.0	5.3%
Industry/Technology Upgrade	370.0	9.3%
Post-disaster reconstruction	1,000.0	25.0%
Grand total	4,000.0	100.0%
Source: www.ndrc.gov.cn; UOB Econ-Treasury estimates		

What is even more important is the fact that fiscal deficit for China, as a result of the stimulus plans, would rise to about 3% of GDP in 2009, from about -0.4% in 2008 and amounting to a 2.4% point jump. Even during the depths of Asian financial crisis and the tech bubble burst, China's fiscal deficits were capped below 2.5% of GDP (China's stimulus measures in Asian financial crisis were about 1.2% of GDP). The last time China ran up such a large deficit was in 1979 when the country just opened