China

UOB Economics Projections	2006	2007	2008F	2009F
GDP	11.7	11.9	10.0	8.3
CPI (average, y/y)	1.5	4.8	6.0	3.0
Current account (% of GDP)	9.5	11.3	4.4	2.1
Fiscal balance (% of GDP)	-1.3	0.7	-0.4	0.2

The RMB's appreciation pace came to a halt in 3Q08 after rising 6.5% against the USD in 1H08. With the Chinese authorities continue to take an easier stance, we see limited upside to the RMB especially into 2009, which is going to be an even more challenging year for the global economy. We are maintaining our end-2008 RMB forecast at 6.70/USD, which we had already lowered from earlier forecast of 6.80. We are also cutting significantly our end-2009 RMB projection to 6.50/USD from our earlier call of 6.37.

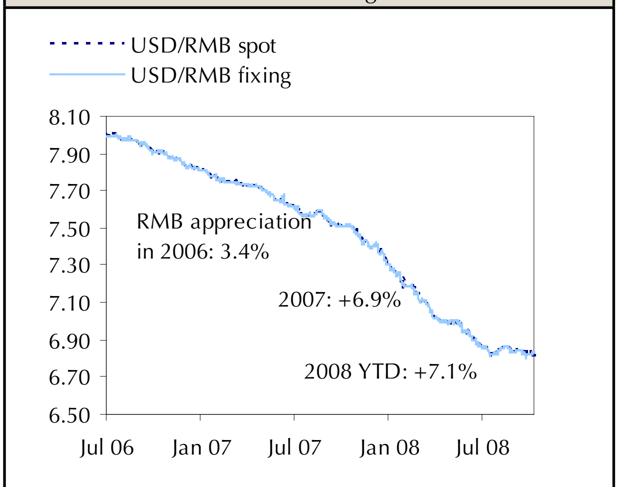
The PBoC turned out to be the first Asian central bank to reverse its tight policy, cutting interest rates in Sep. Subsequently, it also made further reductions on 8 Oct after global central banks announced joint interest rate moves. These quick decisions underscored policymakers' concerns of both the international environment and its impact on the export-dependent domestic sector. We expect at least another five interest rate reductions of 27bps each before middle of 2009, bringing the key 1Y lending rate to 5.58% by end-1H09.

Signs of softening domestic economic activities are emerging despite recent batch of data suggesting that growth momentum remains steady. Exports demand is expected to come under pressure given the importance of G3 demand. 2009 looks to be a challenging year globally as the deleveraging process in the global banking system is likely to peak. We are cutting our forecast for China's GDP growth to 8.3% for 2009, from our earlier projection of 9.5%.

RMB Appreciation to Slow

The once-steady RMB's appreciation pace came to a halt in 3Q08, compared to the 6.5% rise against the USD in 1H08 and 6.9% gain in 2007. With the US credit crunch spreading to other parts of the world, and the real impact being felt in China especially in the export-dependent sector, the authorities continue to take a more proactive approach in managing the economic levers. As a result, the RMB has waned against the USD in 3Q08 as alarm bells have begun to ring as early as June after reports of failures of exporters along the coastal regions as orders dwindled.

USD/RMB Exchange Rate



Source: CEIC, UOB

The PBoC has since Sep reversed its tightening policy stance by cutting interest rates. It is therefore not surprising that the RMB's strength has waned in tandem of a firmer USD as flight to safety intensified along with the deepening of the US credit crisis. The USD strength was further supported after the bankruptcy of Lehman Brothers in mid September and the continued freezing of credit market conditions resulted in heightened risk aversion behaviour. With the USD still in favour in the current flight-to-safety environment and an accommodative PBoC policy stance, we see limited upside to the RMB especially into 2009, which is going to be an even more challenging year for the global economy.

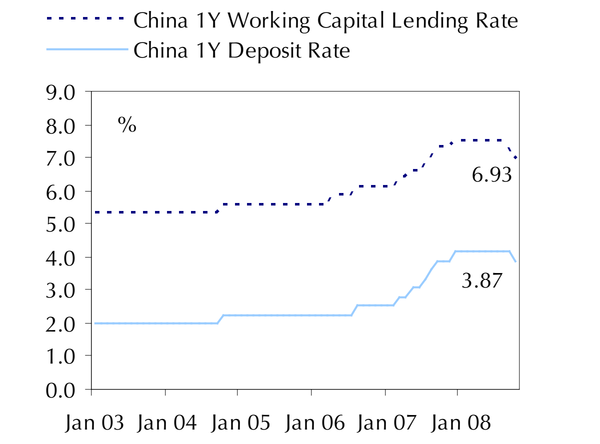
We are maintaining our end-2008 RMB forecast at 6.70/USD, which we had already lowered from earlier forecast of 6.80. We are also cutting significantly our end-2009 RMB projection to 6.50/USD from our earlier call of 6.37.

PBoC Easing Cycle To Accelerate

PBoC on 15 Sep surprised the market with a reduction of its benchmark 1Y lending rate by 27bps to 7.20%, but left the benchmark 1Y deposit rate unchanged at 4.14%. Subsequently on 8 Oct, PBoC also made another 27bps cuts to its lending and deposit rates and reserve requirement ratio after global central banks led by the US Fed made a coordinated interest rate reductions on that day as part of their efforts to contain the global credit crisis.

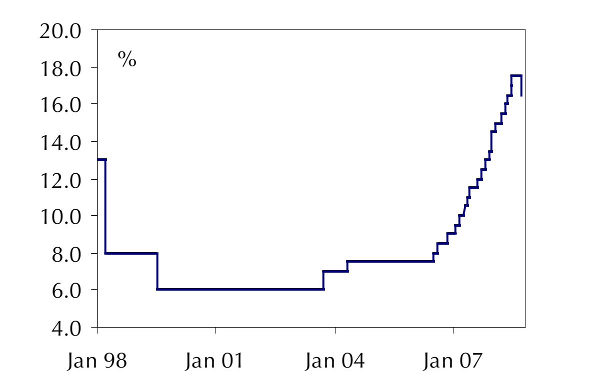
The latest efforts on 8 Oct brought 1Y lending rate down to 6.93% from 7.20% and the 1Y deposit rate to 3.87% from 4.14%. The reserve requirement ratio was cut-50bps.

China: 1Y Lending and Deposit Rates



Source: Bloomberg, UOB

China: Bank's Reserve Requirement Ratio



Source: Bloomberg, UOB

One surprise element in these PBoC decisions was speediness of the decisions. The market has already anticipated a shift in policy as early as July when the RMB was seemingly stuck against the USD and top central government officials and bureaucrats made surprise and unprecedented visits to companies in export-dependent coastal provinces and cities. In addition, continued deceleration of inflation (to 4.9%y/y in August from 6.3% in July and 7.8% in 2Q08) left room for further flexibility to ease policy. The deepening of the US credit crisis was obviously another major consideration for the policy-makers, which is likely to create further downside bias to China's economic growth, especially into 2009.

While the move effectively ended China's tightening policy that began almost three years ago, the PBoC is still cautious as reflected in the RRR cut which only applies to smaller financial institutions and the deposit rate was untouched. It should be noted that the central bank is viewing China's current slowdown a case of "soft landing" and may be uneasy about the risk of creating a loose credit condition too early.This is also reflected in its decision to temporarily shelve the 5% tax on interest income from individual savings account, as a step to make the cut on interest rate for palatable for savers and reduce the risk of excessive spending. Recall that the central bank had aimed selectively at easing conditions for these borrowers earlier, after the Sichuan earthquake in May.

Nevertheless, the continued deterioration of the global credit environment is likely to force China's hands to speed up its policy loosening process. As such we see at least another five interest rate reductions of 27bps each before middle of 2009, bringing the key 1Y lending rate to 5.58% by end-1H09.

Lowering Growth Forecast

The recent batch of data from China suggests that growth momentum remains steady, though some key figures are showing some signs of softening. In particular, industrial production data has been decelerating through the year, slowing to 12.8%y/y vs. 14.7% in July, and down from the 16.2% pace in 1H08 and 17.5% in 2007. However, exports demand continued to surprise, with a stronger than expected rise of 21.1%y/y in Aug compared to 26.9% in July, and on par with the 22% gain seen in 1H08. The question is how sustainable this rate of export growth would be on the back of the 27% rise in exports in 2007 and that the US credit crisis appeared to be hitting Main Street as well. Exports demand is likely to trend lower from here on and possibly to just around

15% for 2009, given that demand from G3 accounted for more than 30% of China's exports in 2007.

However, external weakness is expected to be at least partially supported by continued private spending. Retail sales have been rising at an average rate of 22% in the first 8 months of 2008 (Aug: 23.2%y/y), outpacing the 17% rate in 2007. While the proportion of private spending has eased to just 37% of GDP in 2007, there is still room for increase given that the average is around 42% during the 2000-2006 period. Outlook for capital formation and private investment less certain as it is highly correlated with exports sector, which we expect to decelerate through 2009 and possibly 2010 given the extent of the global credit crisis which is still evolving.

Another positive factor that is very likely to come into play is a more expansionary fiscal policy, given the prospects of decelerating external demand. The upcoming Communist Party Central Committee meeting (9-12 Oct) is likely to lay the groundwork for such a move. With the beginning of the monetary easing cycle, the likelihood of a fiscal plan has actually become greater in order to maintain policy consistency. One element of the stimulus package could involve a personal tax cut, which we estimate could unleash an additional RMB200bn to RMB300bn of spending, or around 1% of China's GDP.

Nevertheless, we expect 2009 to be a challenging year globally as the deleveraging process in the global banking system is likely to peak. The fiscal stimulus package, if there is one, is not expected to fully cushion the impact from an external demand slowdown. Against this background, we are cutting our forecast for China's GDP growth to 8.3% for 2009, from our earlier projection of 9.5%.