

China

UOB Economics Projections	2008	2009	2010F	2011F
GDP	9.0	8.5	9.5	8.3
CPI (average, y/y)	5.9	-0.7	3.6	4.7
Current account (% of GDP)	9.3	5.8	3.6	3.4
Fiscal balance (% of GDP)	-0.4	-2.2	2.8	2.0

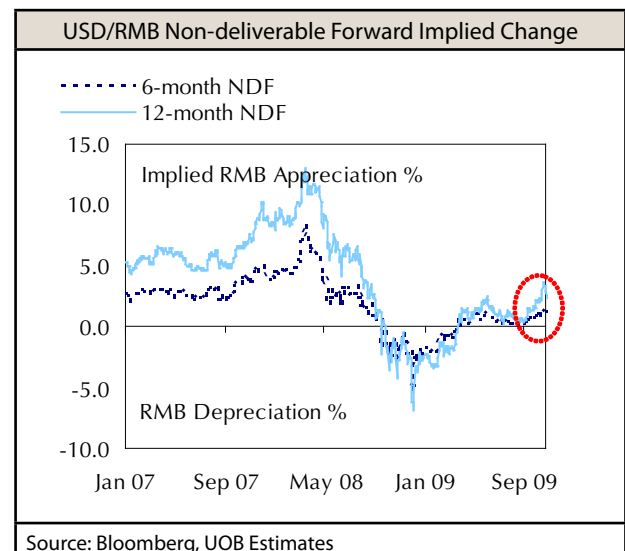
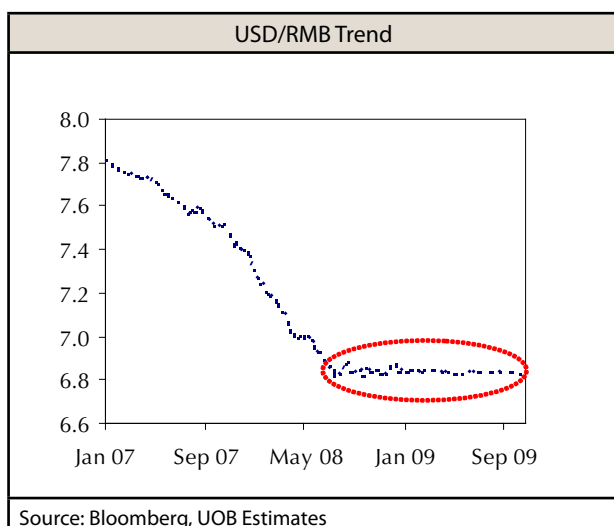
- *With the delay of the US Treasury's report and China's Pres Hu visit the US on 12-13 Apr, US-China dialogue in late May, and G20 Summit in late June, the possibility of changes in China's exchange rate policy in the next few months has actually increased. However, we see low risk of a RMB revaluation and band widening, but expect gradual appreciation to begin by second half of the year. We maintain our USD/RMB forecast at 6.77 by end-2010.*
- *China's monetary policy normalization is on track, with the central bank favouring changes in reserve requirement ratio before moving to tighten through interest rate policy, in line with the move in exchange rate. However, the pace is likely to be measured and gradual. We maintain our call for China's 1Y lending rate to rise to 5.85% by end-2010.*
- *Data from Jan-Feb continue to point to growth momentum staying intact in China, with help from low base last year. While deceleration is apparent in fixed investment as a result of tighter policy, overall trend is still positive across all data and policy remains supportive. We are raising our forecast for China's GDP growth to 9.5% from our previous projection of 8.5%.*

RMB: Keeping Watch on Key Events Ahead

As has been the case since July 2008, the USD/RMB continues to hold largely steady, at around the 6.83 level. Pressures for an RMB revaluation/appreciation have built up significantly since the start of the year and intensified further recently as both American and Chinese leaders commented on the subject. In an unusual move, US Pres Obama on 11 Mar said that world would benefit by rebalancing if China moved to a market-based exchange rate system. In an apparent retort, at the conclusion of the annual session of National People's Congress on 14 Mar, Chinese premier Wen Jiabao stood his ground by stating

that the RMB is not undervalued and that calls from other countries for China to revalue the RMB were "unhelpful, even protectionist", and vowed that China will make its own call on currency reform. Since then, a whole host of politicians, central bank officials, and multilateral agencies such as IMF and World Bank had waded in.

Key reasons for the ratcheting up in the rhetoric are the relative weak growth in the G7 economy in contrast to those in the emerging market (especially in developing Asia) has fueled discontent. At the same time, US will be facing mid-



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term elections in Nov, and politicians are under pressure to respond to high jobless rates, weak wage growth, and wide trade deficits. Often trade imbalances and apparent disparity in trade competitiveness are blamed on currency, which is considered to be misaligned or manipulated. Our article in this quarterly suggests there is very little evidence to link currency to trade balances, thus weakening the basis of the conventional wisdom that currency value is responsible trade imbalances.

However, a group of US senators have on 16 Mar introduced a new bipartisan legislation ("Schumer-Stabenow-Graham Currency Exchange Rate Oversight Act of 2010") to lower the threshold for trade sanctions. Instead of labeling "currency manipulation", the new bill requires just the identification of a "fundamentally misaligned", thus attracting punitive trade measures.

Latest developments on the geopolitical front have actually raised the risk that China could make changes to the RMB policy stance. Several important events are coming up in this regard. First off, the US Treasury's report on currencies ("Semiannual Report on International Economic and Exchange Rate Policies") originally due on 15 Apr has been postponed, thus taking the pressure off of naming China as a "currency manipulator". The postponement has actually made it easier for China to make policy changes without appearing to bow to foreign pressures. According to a Reuters report, US Treasury has not identified any country as a "currency manipulator" since 1994, when it last cited China. In the first 6 years of the report (1988-1994), it cited Taiwan 4 times, South Korea 3 times, and China 5 times, for "currency manipulation".

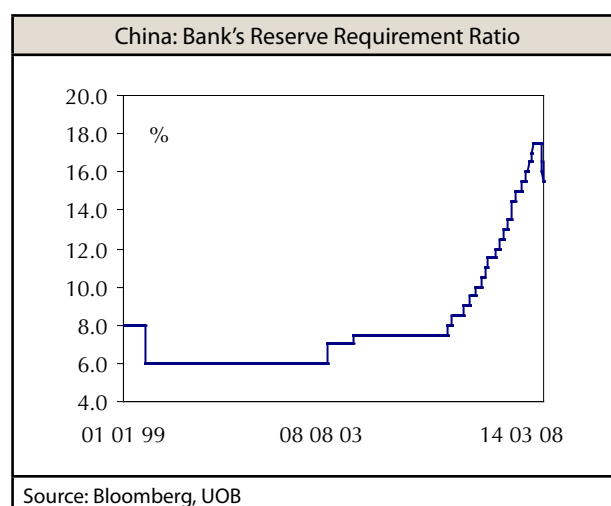
Secondly, Chinese Pres Hu Jintao has agreed to attend an international nuclear summit in the US on 12-13 Apr to discuss possible sanctions on Iran's nuclear plan. This suggests that there may have been some bargaining on other issues, including trade/currency etc, in order for China to attend the summit.

Soon after, top US and Chinese officials will meet in Beijing late May for the US-China Strategic and Economic Dialogue, which will be discussing currency policy and whole host of other issues.

Finally, this will be followed by the G20 Summit on 25-27 Jun in Canada, where trade/currency issues are likely to be on the agenda.

With these event risks lined up, chances of China's currency actions have been elevated in the next two months

especially now that overt pressures from the US govt have been reduced somewhat. We see low risk of a RMB revaluation in the near term, as that option has basically been ruled out by the Chinese government earlier. Even if there was one, the magnitude would probably be similar to the 2.1% reval back in Jul 2005. Another risk is that band widening may be on tap, enlarging the current +/-0.5% band to possibly around +/-0.75% to +/-1.0%, although in practicality this move may not be meaningful as the band limits are seldom tested. For now, we expect USD/RMB to remain steady and then move towards some "crawling appreciation" in the second half of the year. We continue to maintain our USD/RMB forecast at 6.77 by end-2010, or just about 1% lower from current level of 6.827. The non-deliverable forwards (NDF) market is pricing in about 3% pace of appreciation for the RMB against the USD in the 12 month horizon, and 1.6% for the 6-month timeframe.



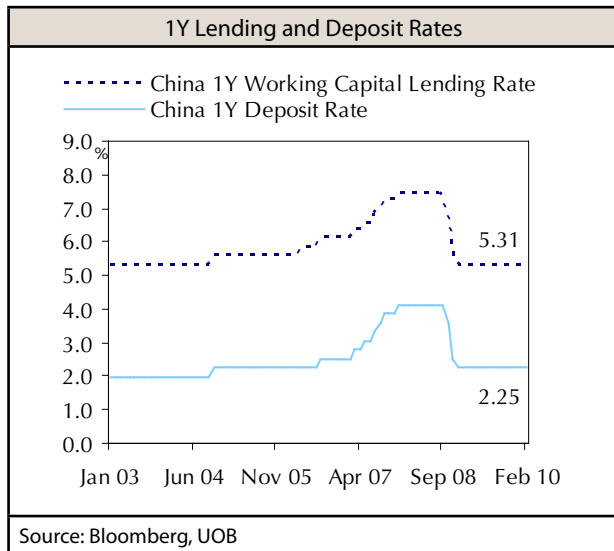
Normalization of Monetary Policy Remains on Track

China's kicked off Asia's monetary policy normalization with surprisingly early hikes in its banks' reserve requirement ratio (RRR) in Jan. With a collective 100bps increase so far in the RRR to 16.5% (for large banks), we expect the figure to hit a record high of 19.5% by end-2010.

It should be noted that the RRR is only one tool in the current policy normalization trend, and is the least disruptive compared to other options (including changes in policy interest rates and RMB exchange rate), as China's banking system remains flush with savings. Loans to deposit (LD) ratio is still relatively muted at around 0.68, which is about the average since 2005. In addition, each 50bps hike in RRR would freeze about RMB200-300bn in terms of savings. Assuming PBoC does carry out a total of 400bps hike in RRR this year, that would freeze about RMB2.4tn of funds, close to the difference between this

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year's reduced new loan target of RMB7.5tn and last year's new lending of RMB9.6tn.

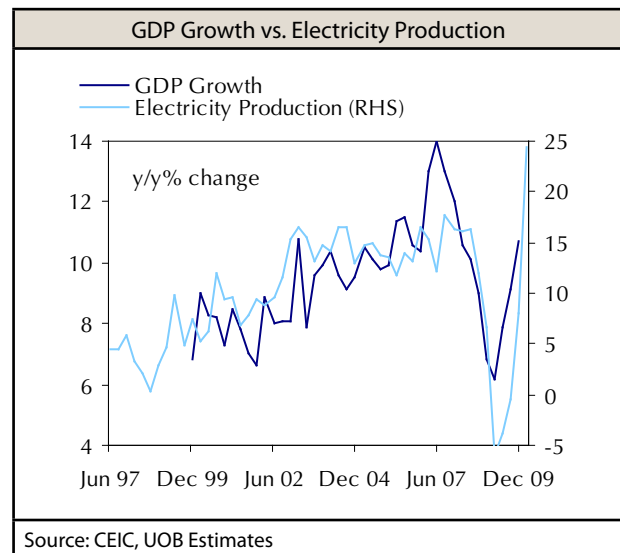


As for interest rate policy, we expect China to hold off normalizing interest rate policy until the second half of this year, and the pace of hikes is likely to be moderate. Among other factors, underpinning our call is that a larger interest rate differential adds further pressures to the RMB exchange rate, with US overnight Fed funds rate nearing zero. Another consideration is the rate hike impact on mortgage servicing, especially for lower income households, in view of China's current heated property market. Our equity research arm estimated that for every 100bps hike in mortgage interest rate, an average Chinese household would pay an additional 5%pt on mortgage servicing burden (i.e. from national average of 62% to 67% of income) (Source: "China Property: Good Things Come to Those Who Wait", pg 12, 2 Mar 2010, UOBKayHian). We maintain our call for China's 1Y lending rate to remain at 5.31% through to mid-2010, before rising to 5.85% by end-2010, and for 1Y deposit rate to rise to 2.79% by year-end from 2.25% currently.

Economic Recovery Momentum Continues in 1H on Base Effect

China's data for Jan-Feb released in early Mar suggest that recovery momentum remaining largely intact, boosted by weak bases a year earlier when the global economic crisis was at its worst. Industrial production rose by about 20.7%/y/y in Feb, rebounding off the low single-digit pace in the same period last year, helped by strong performance in heavy industry sector. Retail sales accelerated by 22%/y/y in Feb, breaking out from the average of 15.5% in 2009.

However, there are some signs that activity may be slowing as policy begins to turn less accommodative. In particular investment activity slowed to about 27%/y/y compared to the above-30% pace during the second half of 2009, and new construction activity slowed to 28%/y/y from the 36-42%/y/y rate seen through 2009. While the Purchasing Managers Index (PMI) remains in the expansionary territory in Feb at 52.0, the headline index has declined for the second consecutive month, for the first time in about a year, as both new orders and new exports order decelerated. In particular, new exports order PMI index settled at 50.3 in Feb, near the low in May last year.



On inflation front, there have been concerns on the pace of increase in consumer prices in China. Indeed, CPI inflation averaged about 2.1%/y/y in Jan-Feb period, up from -0.7% in 2009, while producer prices rose an average 4.9%/y/y in first two months of the year, up from -5.4% average in 2009. Note that base effect is a key factor in both of these indices, and that would keep the figures high in the first half of the year. In the second half, the base effect would reverse itself and could offset the impact in the first half. Secondly, consumer prices have been driven by food components, which were responsible for 1.7%pt, or more than ¾ of the 2.1% rise in Jan-Feb. Prices of non-food components continued to stay subdued as has been the case since 2004. Finally, while headline CPI inflation could rise to about 5% by end-2010, the pace is still not excessive given the 6-8% pace seen during 2007-08.

Electricity production data has been a reliable leading indicator for headline GDP growth, and the latest figure suggests that some headroom remaining at least in the

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first half of the year. As noted in the Jan-Feb data releases, we expect China's economic activity to remain firm in the first half of the year, especially in view of favourable base effect and the continued economic recovery in the US (Bloomberg consensus: +3% GDP growth in 2010 vs. -2.4%

in 2009). In addition, the pace of policy withdrawal in China is likely to be measured and gradual, which would help sustain growth for this year. We are raising our forecast for China's GDP growth to 9.5% from our previous projection of 8.5%.