China

UOB Economic Projections	2009	2010	2011F	2012F
GDP	9.2	10.3	9.2	8.2
CPI (average, y/y %)	-0.7	3.3	5.4	3.9
Current account (% of GDP)	6.1	5.1	2.9	2.4
Fiscal balance (% of GDP)	-2.3	-1.7	-0.2	-0.5

- *There has been a divergence between onshore CNY and daily fixings as well as between onshore and offshore RMB prices, which can be attributed to the uncertain global environment, and not a change in FX policy. For now, China's gradual appreciation FX policy is expected to remain. We are adjusting our end-2011 USD/CNY forecast marginally, to 6.30 from 6.35 previously, as well as our end-2012 forecast to 6.05, from 6.10 previously.*
- *Along with other Asian central banks which shift focus to growth, we expect China's interest rate and RRR cycle to come to an end. This means that the 1Y lending rate will be maintained at 6.56% and RRR at 21.50% at least through mid-2012.*
- *Growth headwinds continue with unresolved sovereign debt crisis in Europe and sluggish recovery pace in the US, although a hard landing scenario China remains a low probability for now. We are trimming our projection for China's 2012 growth to 8.2% from 8.5% previously.*

RMB Policy Remains On Track

After strengthening since the second depeg in Jun 2010 and rising more than 6% against USD by early Aug 2011, the RMB has since been moving sideways. This is an apparent response to uncertainty in Eurozone sovereign debt crisis, which has been ongoing since at least Jan 2010. With no firm and credible resolution so far to deal with Greece's substantial sovereign debt burden (projected at 160% of its GDP), financial asset prices have reacted in significant volatility since Jun, swinging in either direction in reaction first to US debt ceiling negotiations, and then conflicting signals and messages out of Europe and elsewhere in dealing Eurozone's crisis. It is not surprising to see such move from RMB, as the currency had previously halted its appreciation from Jun 2008 just as the US subprime mortgage crisis started.

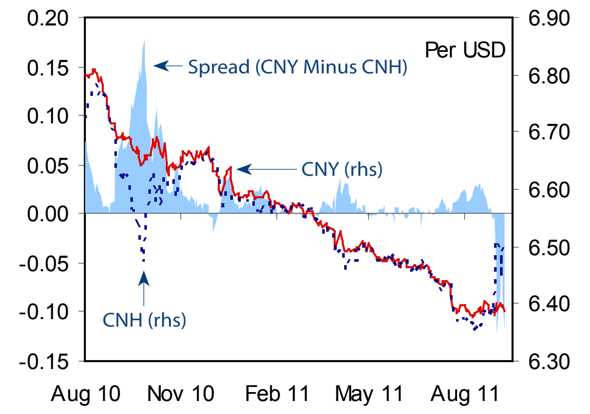
So far this year, onshore RMB has appreciated about 2.9% by end-September, or an annualized rate of 3.9%, to 6.3976/USD. This is very much on track of our original forecast of 6.40 for end-3Q and expectation of annual 3-5% gain. It should be noted that since mid-Sep, the daily central parity fixing has pulled away from spot prices, in that the fixings have been firming against the USD, just as spot prices stagnated. This phenomenon is likely to be temporary and due to two reasons: 1) as mentioned above, market uncertainty and risk aversion causing a pullback from risky assets; and 2) in addition to maintaining the appreciation trend, the fixings are possibly also reacting to renewed political pressures from US lawmakers on China's currency policy. As we continue to see "muddling through" in dealing with the current Eurozone sovereign debt crisis, China's FX policy is set to maintain its gradual and appreciation policy for now. We are adjusting our end-2011 USD/CNY forecast marginally, to 6.30 from 6.35 previously, as we see spot prices catching up with the midpoint in 4Q. Going into next year, the same 3-5% appreciation trend should continue to prevail, assuming no major crisis or event breaking out. We also adjust our end-2012 forecast slightly, to 6.05 from 6.10 previously.

In offshore trading, some divergence from onshore RMB also appeared recently, with USD/CNH trading higher than USD/CNY (29 Sep: 6.4830 vs onshore 6.3974, or a spread of 856 points in favour of USD/CNH compared to average of minus 96 points between Jan-Aug). This is unusual although we should note the history of offshore RMB trading has been relatively short, having started in late 3Q 2010. In normal market conditions, expectations of appreciation drive up demand for offshore RMB, hence USD/CNH normally trades below USD/CNY. This recent phenomenon is likely to be transitory, as a result of the global risk aversion sentiment which shuns risk assets including CNH, increases the demand for USD liquidity (very much similar to development in Singapore in Aug/Sep that caused swap offer rates to turn negative), as well as concerns about China's outlook itself. This is reflected in selling pressures in "dim sum" bonds in HK.

China

For example, the SinoPac Dim Sum bond index Total Return index is down by 2.6% since the series started on 31 May, with the index falling off steeply in Sep. We do not see the current situation in offshore RMB a harbinger of a shift in China's FX policy stance (in fact, the ongoing strengthening of fixings basically has ruled out any relaxing of RMB appreciation stance) and the gap should restore to normal when global market conditions stabilize.

China: Onshore CNY vs. Offshore CNY ("CNH") Trend



Source: Bloomberg, UOB Economic-Treasury Research

As for interest rate policy, we believe the current uncertain global market conditions and Eurozone's ongoing sovereign debt crisis have reduced significantly the odds of further interest rate and reserve requirement ratio (RRR) increases, at least in the near term. Taiwan's central bank was the latest to halt its interest rate hike cycle at its 29 Sep meeting, following the footsteps of other Asian central banks as focus shifts from fighting inflation to ensuring economic growth is not unduly restrained in view of slowing external demand. We expect the upcoming Singapore's monetary policy review in early Oct to announce an easing of policy as well. In China's case, recall that in the current tightening cycle, PBoC has raised interest rates a total of five times since Oct 2010, with the last move on 6 July, while RRR was hiked a total of 12 times (for major banks), to current rate of 21.50% (last move was on 14 Jun). Given the headwinds from Europe and the US, we think that the rate and ratio tightening cycle to be on hold for now in China, keeping the 1Y deposit rate at 3.50%, 1Y lending rate at 6.56%, and RRR at 21.50%. However, as we expect China's inflation rate to continue to stay above the 1Y deposit rate in 2012, there is still a risk that PBoC could resume its rate hike cycle next year, especially if global conditions stabilize and domestic environment remains "overheated" in terms of prices and loans demand.

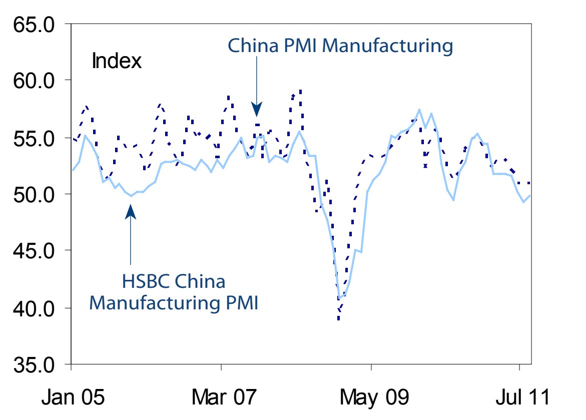
China: 1Y Lending And Deposit Rates

Source: Bloomberg, UOB Economic-Treasury Research

Growth Headwinds Remain

China's latest batch of data releases show a moderating momentum that is largely in place, and a low probability of a crash/hard landing scenario. Leading indicators such as the NBS PMI index remains in the expansion zone at 50.9 vs. 50.7 in July, although the SME-heavy HSBC PMI has been struggling in contraction zone for the third straight month, with the latest reading of 49.9 for Sep. This shows that smaller businesses and manufacturers are bearing the brunt of the current tight credit environment and external demand weakness. While both PMI indices appear to disagree currently, overall both series do tend to correlate quite well, as shown in the chart. We are not unduly worried about macro conditions at this point, but will keep an eye on the PMI especially if the series decelerate towards the 40-level, the lows during the 2008/09 global financial crisis.

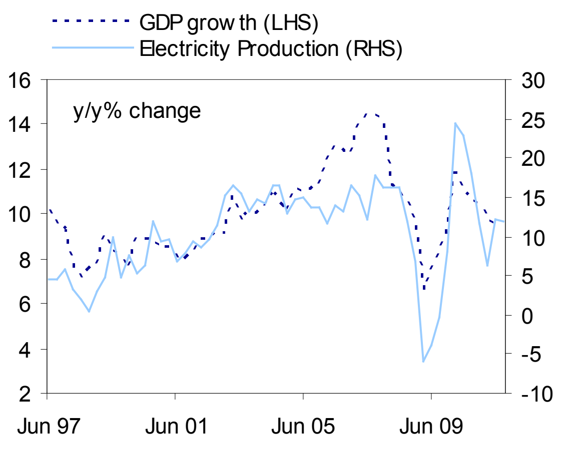
China: NBS PMI Vs HSBC PMI



Source: CEIC, UOB Economic-Treasury Research Estimates

China

China: GDP Growth vs. Electricity Production



Source: CEIC, UOB Economic-Treasury Research Estimates

Other data generally show a supportive backdrop, with industrial production activity in line with expectation, and retail sales showing steady growth. As should be expected, fixed investment growth eased, but only modestly, given the tight policy environment. While trade balances have been surprisingly strong especially in Jun and Jul, we expect exports growth to continue to slow in the months ahead, moving on the downtrend that has been established since hitting the peak growth of 48.5%y/y in May 2010.

These data largely reaffirm our current view that China is set to moderate gradually into 2012, and that a "hard landing" situation is not our core view. There are concerns though about the state of the property market and the extent of banks' exposure to local government debt. However, to some degree, these issues are more manageable compared to what Eurozone or even the US is facing, given the availability of domestic resources to deal with any turbulence ahead. Looking ahead, headwinds from global economy will certainly weigh on China's growth outlook in the quarters ahead, and should see 2H2011 headline growth hovering at the 8.5-9.0%y/y pace vs. average of 9.6% in 1H, and decelerating further to around 8% in first half of 2012. For now, we are keeping our 2011 GDP forecast unchanged at 9.2%, and trimming 2012 projection to 8.2% from 8.5% previously.