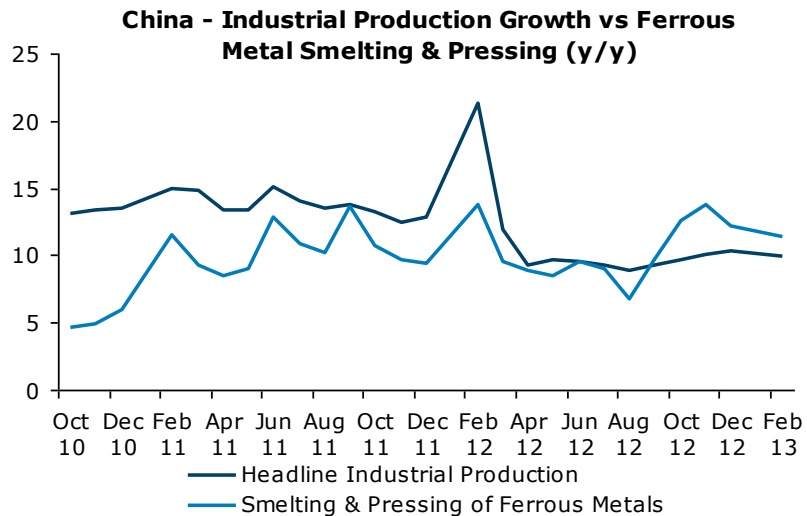
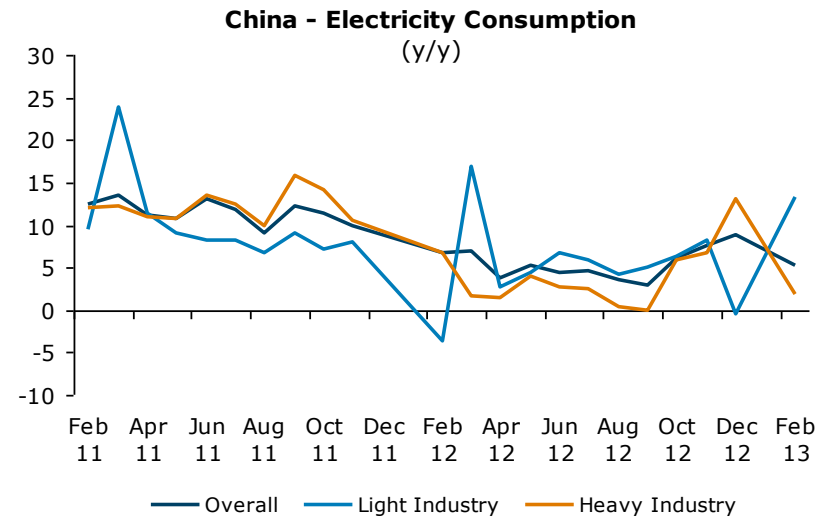
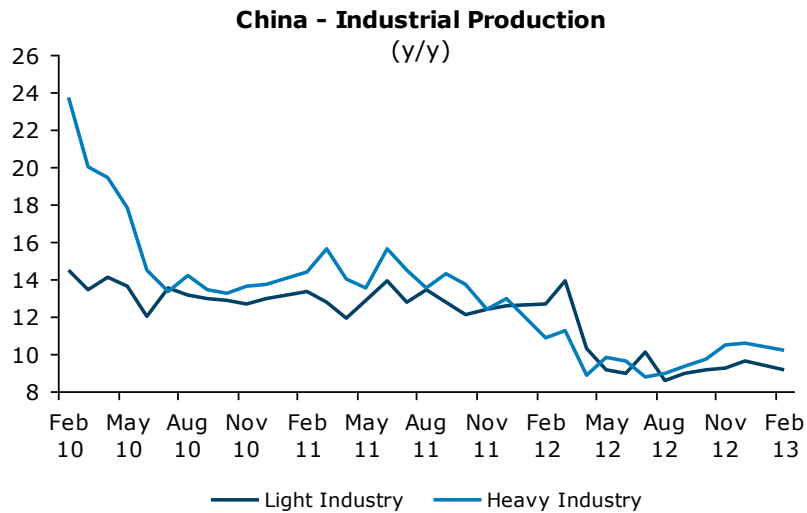


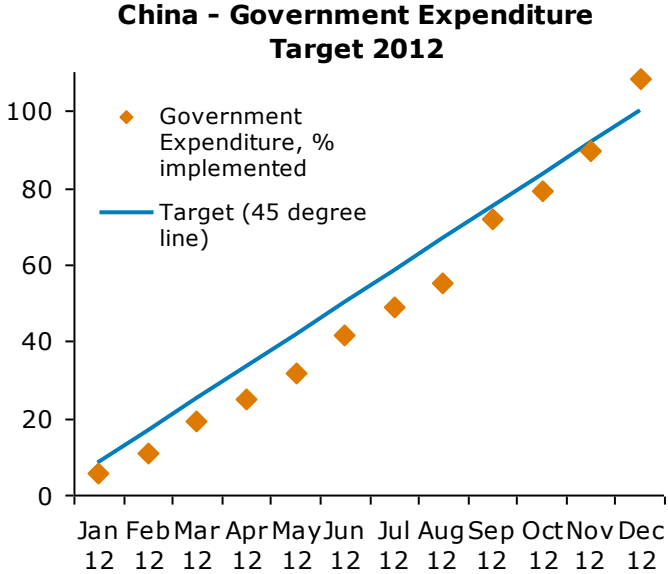
China: An Old-Fashioned Recovery, Headwinds Ahead

Li-Gang Liu
Chief Economist, Greater China
MAR 2013

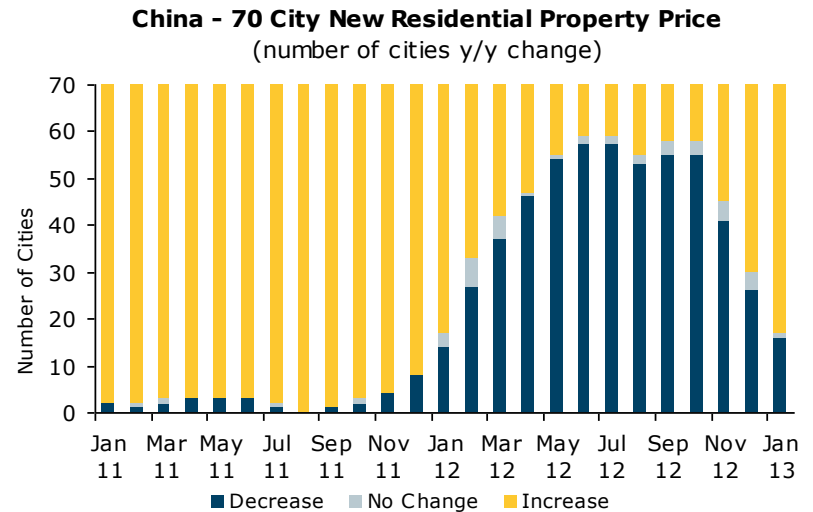
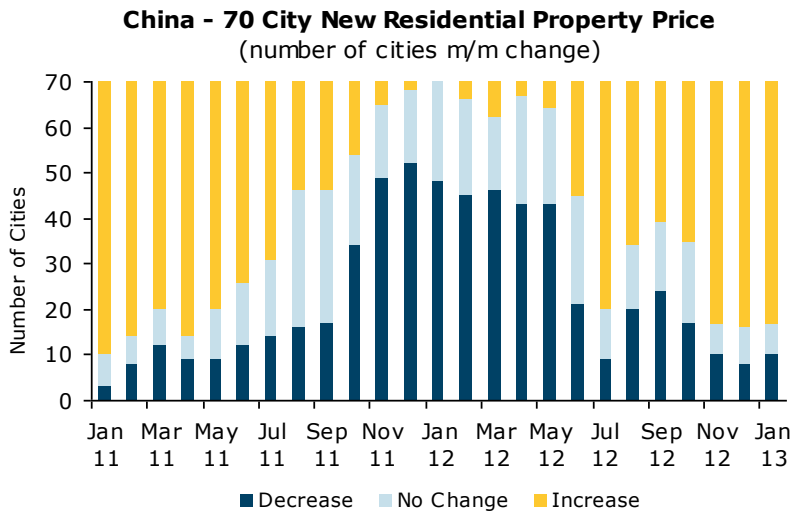
Industrial production rebounded, led by the heavy industry sector



Fiscal policy implementation had sped up after September 2012; newly started projects surged in Q4.

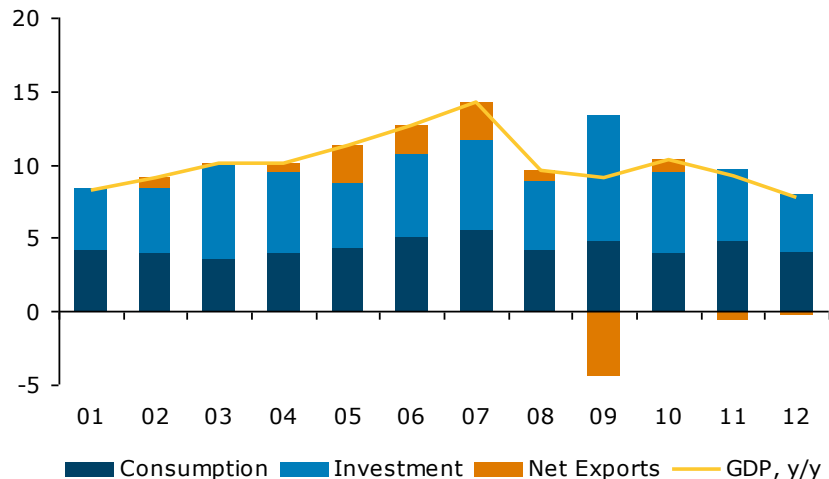


Meanwhile, property market warmed up in H2 2012

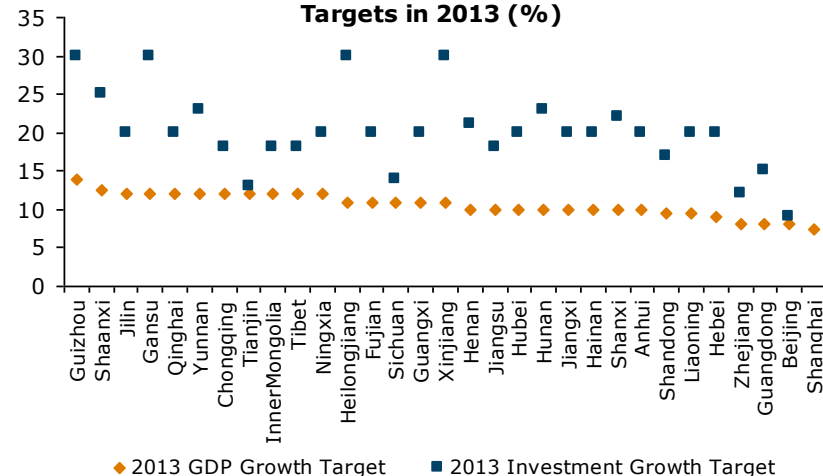


But this is an old-fashioned recovery, driven by investment. No visible change in China's economic structure

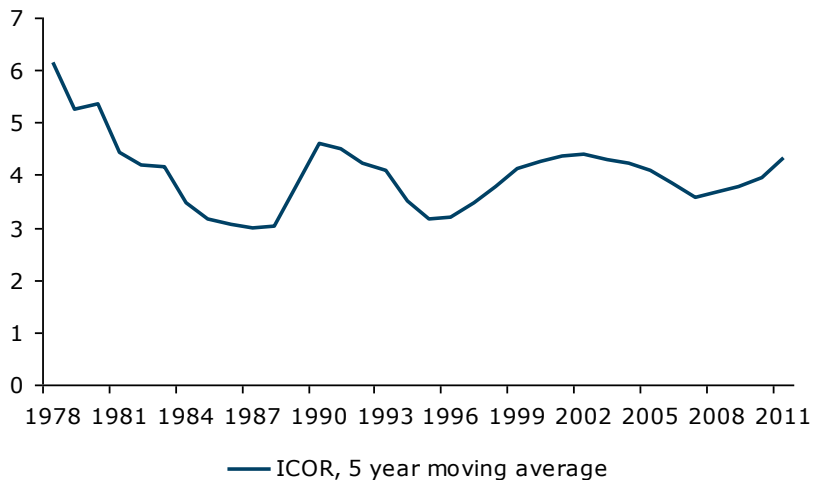
China - Contribution to GDP Growth



China - Provincial Growth and Investment Targets in 2013 (%)



China - Incremental Capital Output Ratio



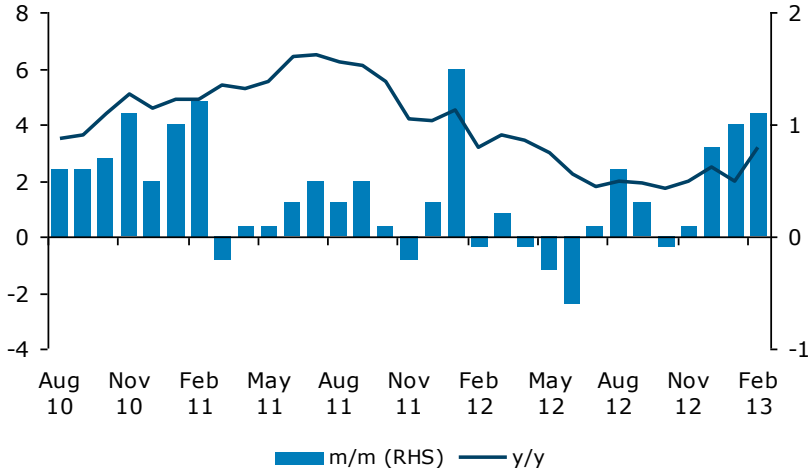
Incremental Capital Output Ratio

	Period	Avg. GDP Growth	Investment Share of GDP (%)	ICOR
China	1981-1990	9.3	35.2	3.8
	1991-2000	10.5	37.8	3.6
	2001-2011	10.6	43.4	4.1
Japan	1960-70	10.4	26.1	2.5
Korea	1981-91	9.7	30.4	3.1

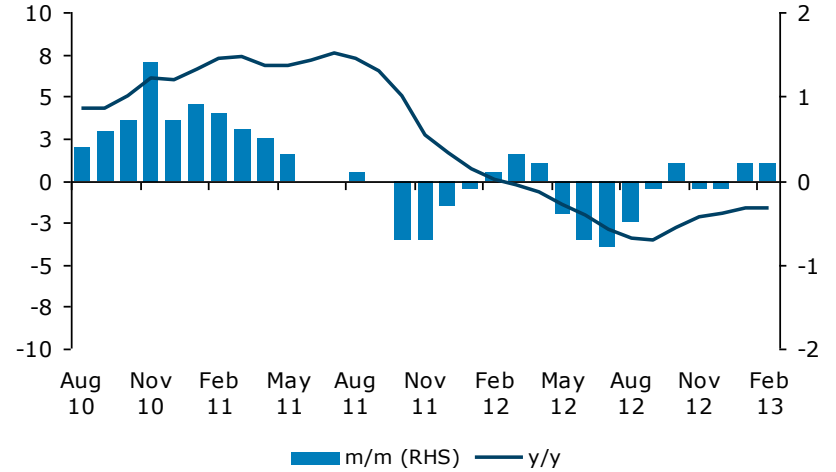


Inflation will return as a major threat

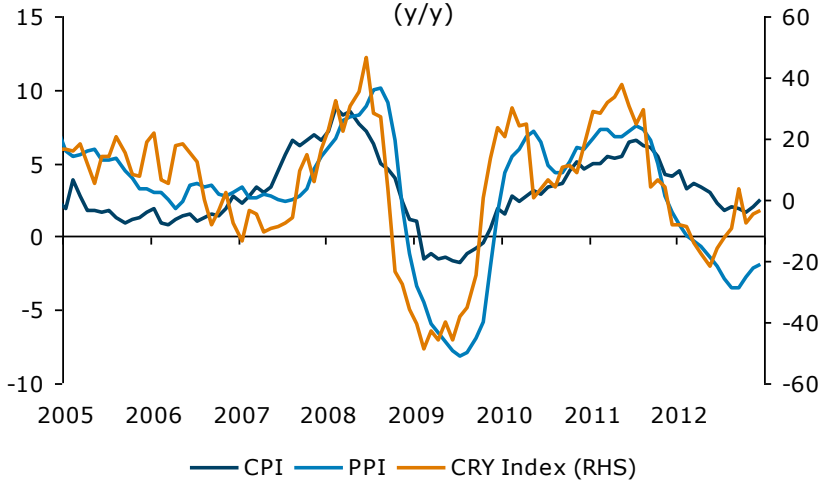
China - CPI Inflation



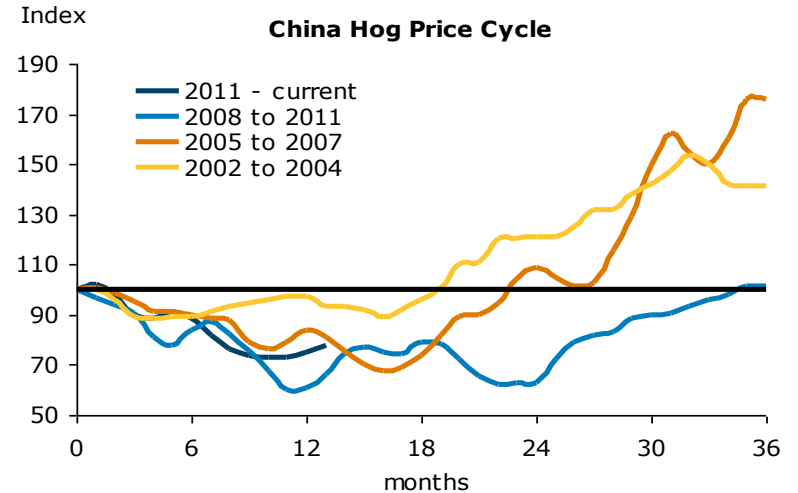
China - PPI Inflation



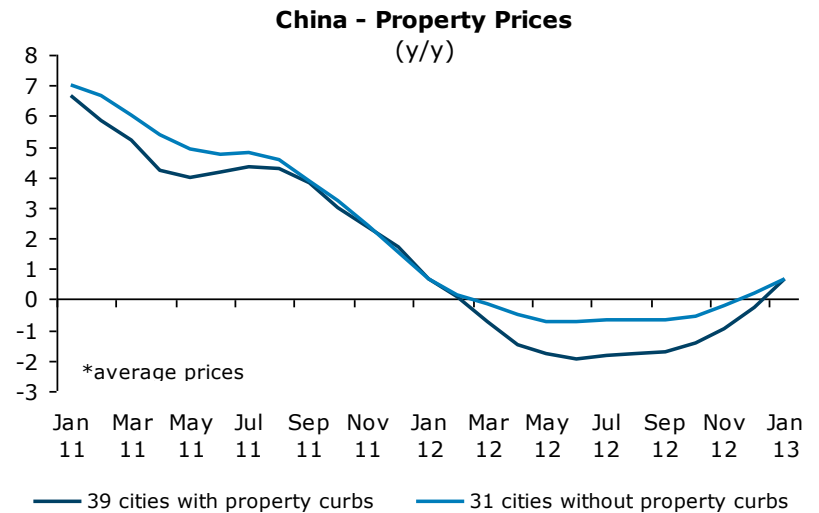
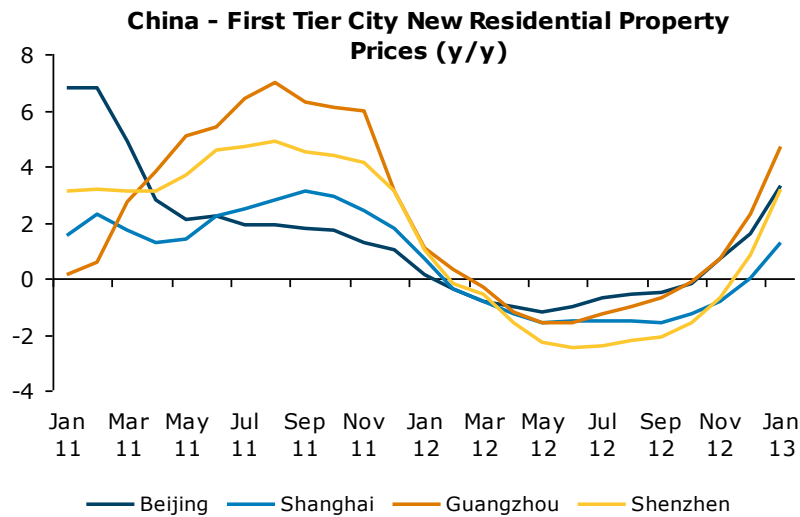
China - Inflation vs CRY Index (y/y)



China Hog Price Cycle

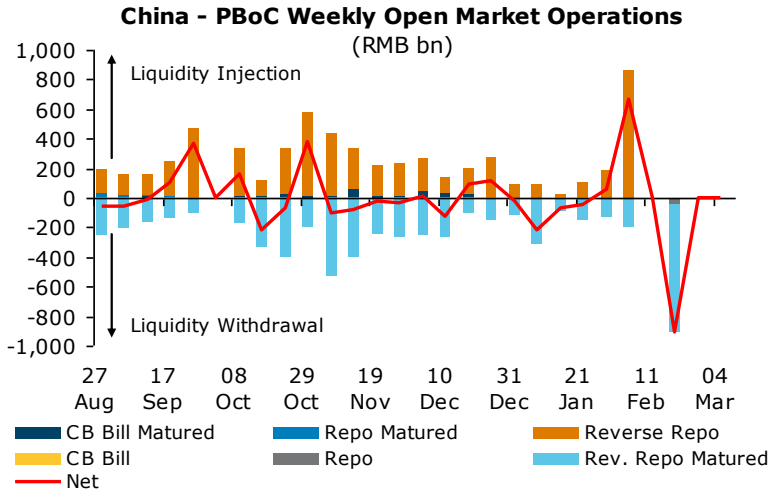


Risk of asset bubble will be rekindled on the back of re-affirmed urbanization drive



Monetary policy in 2013: A tightening bias has set in?

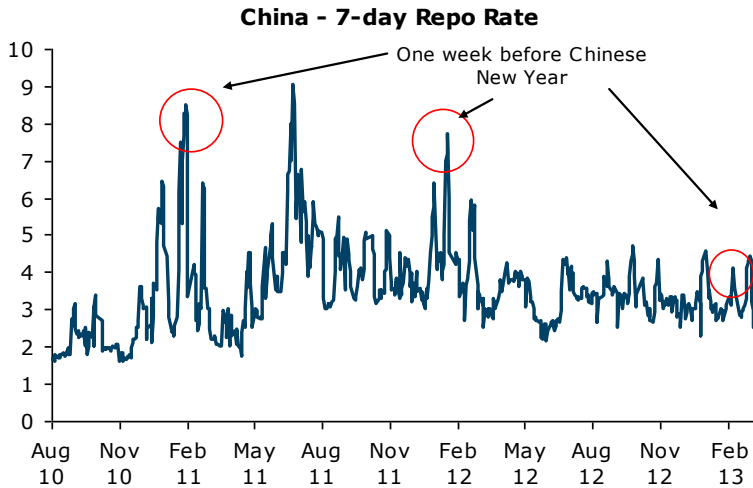
PBOC resumed repos to drain liquidity from the open market



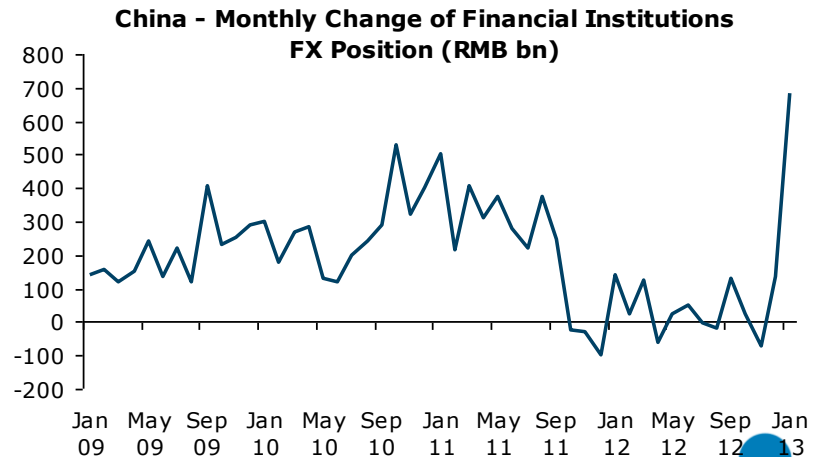
Food prices hit record high, raising inflation concerns



Market rates much more stable this year, suggesting relaxed market liquidity



Capital inflows rebounded in Q4 2012 and are expected to surge in Q1, prompting repos operations



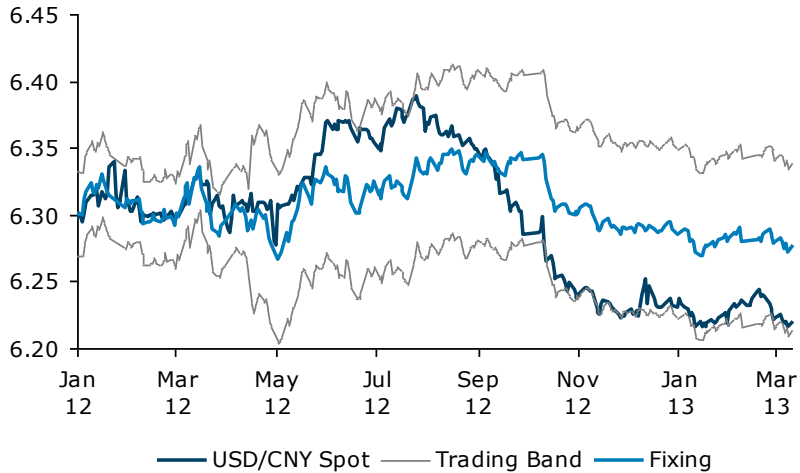
Fear of hard landing has diminished and an 8% growth can be obtained; but inflation will rebound and the renewed risk of asset bubble will return

- We hold a cautiously optimistic view on China's economic outlook over the next year. The economy should see a continuous and modest upturn in 2013, with an annual GDP growth rate at 8.1% y/y for the whole year.
- Inflation remained tamed in Q4 2012, but will start to rise in Q1 2013. Inflation is expected to reach 4% y/y in late Q2 or early Q3 2013. We forecast China's inflation will increase by around 3.5% to 4% in 2013.

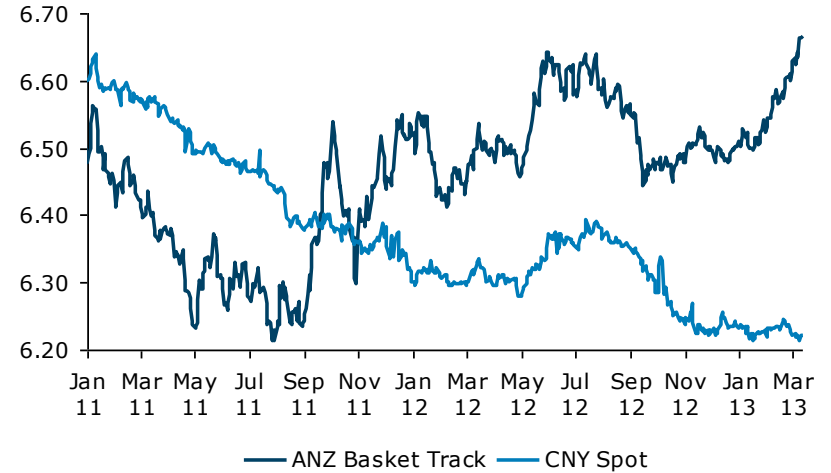


After the enlargement of the trading band, CNY's one-way bet is now difficult to realize, but two-way fluctuation is here to stay.

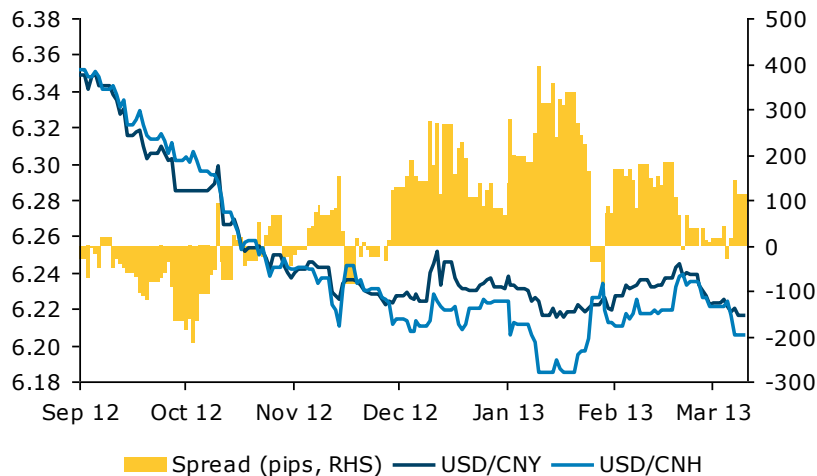
USD/CNY



China - CNY Basket

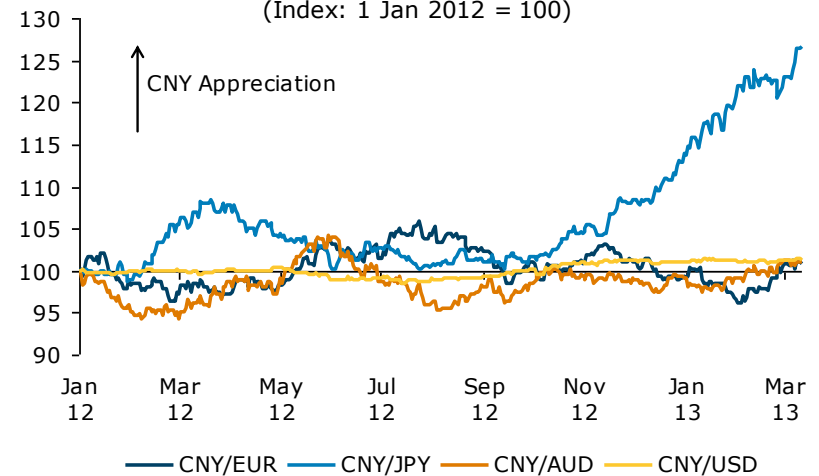


China - CNY and CNH Rates



CNY Exchange Rate

(Index: 1 Jan 2012 = 100)



China: Medium-term Outlook

Political transition is unlikely to change economic policy: A Case study of the 12th five-year plan

Phase 1: 2 years (March 2008 – February 2010)

- The State Council organised an interim evaluation of the 11th FYP through all ministries, provincial governments and independent research institutes including the World Bank, Asian Development Bank, and universities. A report was submitted to NPC Standing Committee.
- The State Council arranged an initial research of 39 topics of 8 areas in the form of research projects. The research report was submitted to the Party's Politburo Standing Committee which determined the directions and issued a "circular" to relevant units (February 2010).

Phase 2: 8 months (February 2010 – October 2010)

- The State Council Vice-Premier Li Keqiang led drafting of the proposal with all nine members of Politburo Standing Committee involved. Each of them was responsible for an area of "investigation and research". All ministries and provincial governments draft their own plans concurrently.
- At the 5th Central Committee meeting held in October 2010, Premier Wen presented the final proposal for consideration, and then announced the approved proposal.

Phase 3: 5 months (October 2010 – March 2011)

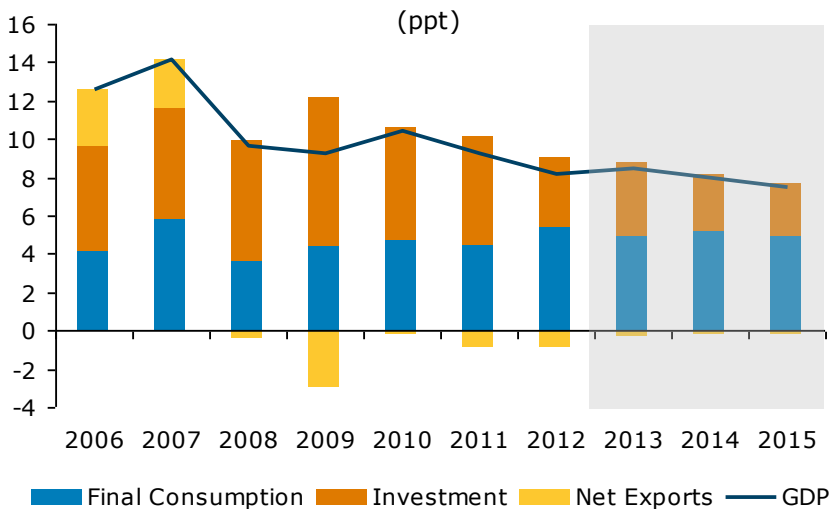
- The State Council prepared the FYP Outline for further deliberation and public consultation and presented the Outline to the Politburo. It was also vetted and approved by NPC in March 2011.

The Medium-Term Outlook Remains Positive

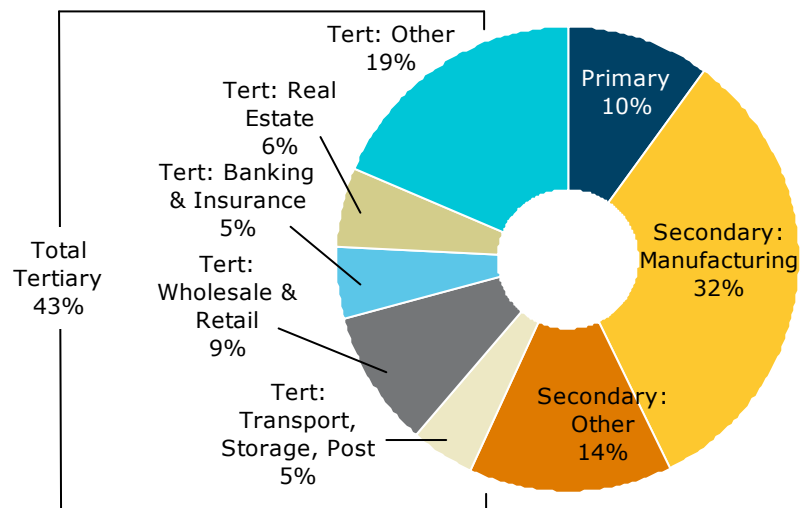
- § By any standard, we cannot regard an economy still growing at 7-8% with inflation capped at 2-3% as a hard landing economy, let alone for a second largest economy in the world.
- § While structural issues will continue to challenge China's sustainability, we think cyclical factors will still dominate China's growth by 2015. Chinese growth at around 7 to 8% can still be maintained with relative ease.
- § The 12th 5-Year Plan (2011-15) indicates the government is determined to rebalance the economy with an emphasis to boost consumption, move up technology ladder, increase energy efficiency, and reduce CO₂ omissions.
- § If these targets progress can progress as planned, the economic fundamentals for a more sustainable growth in the following five years (2015-2020) will become more solid.
- § Our core view remains that China's growth will be domestic demand driven in the next 3 years; Resources-rich economies will benefit from an ever enlarged Chinese market.

From now to 2015, the overall policy emphasis will be to boost consumption and gradually reduce the importance of investment

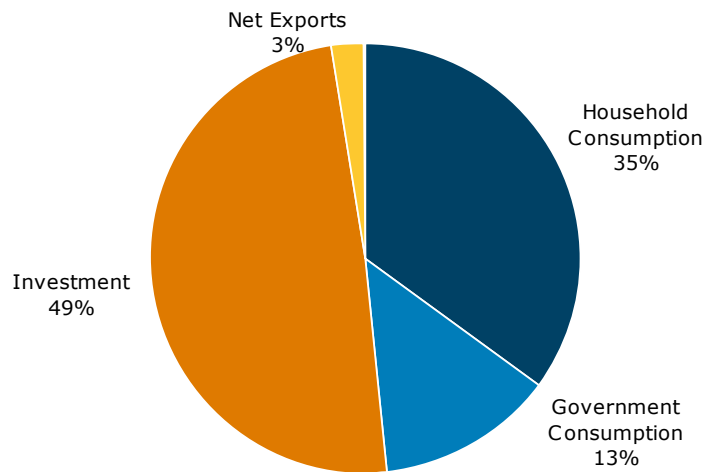
China - Contribution to GDP Growth



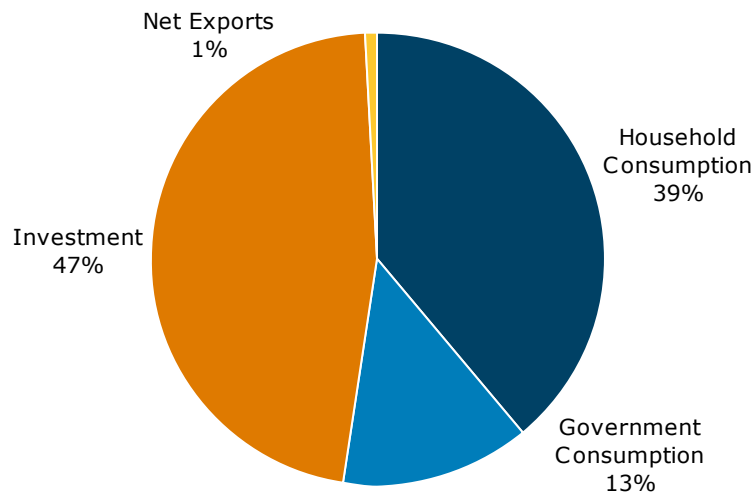
China - GDP Composition 2011



China - GDP Composition (2011)



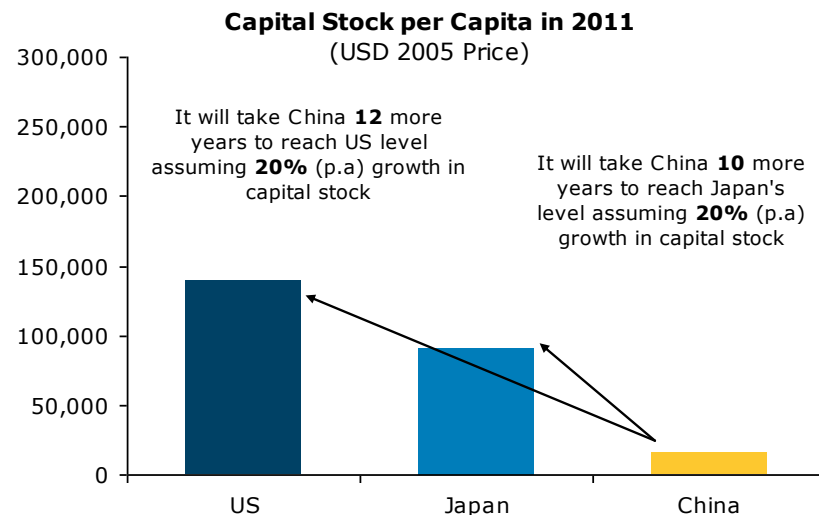
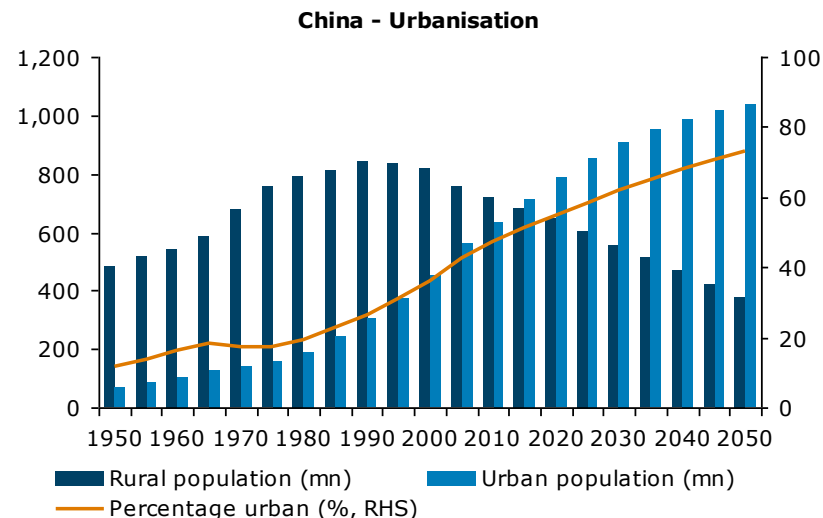
China - GDP Composition (2015)



Urbanisation is to be a major driver for growth in the medium to long run

China's urbanisation also requires huge infrastructural investment

- **350 million people will be added to China's urban population.** That's three times the amount of rural Chinese (103 million) that have migrated to the cities since 1990
- 1 million kilometres of new road and **28,000 kilometres of metro rail** will be laid
- **170 mass-transit systems will be built** - twice the number that all of Europe has today
- **40 billion square metres of floor space** will be built to construct five million buildings - the equivalent of building two Chicago's every year
- **97 new airports will be built** and one in every ten planes assembled by Boeing and Airbus will be delivered to China
- **Energy demand will more than double from 60 quadrillion British thermal units (QBTUs) to between 123 QBTUs and 142 QBTUs** - equivalent to 25% of the world's total energy demand today



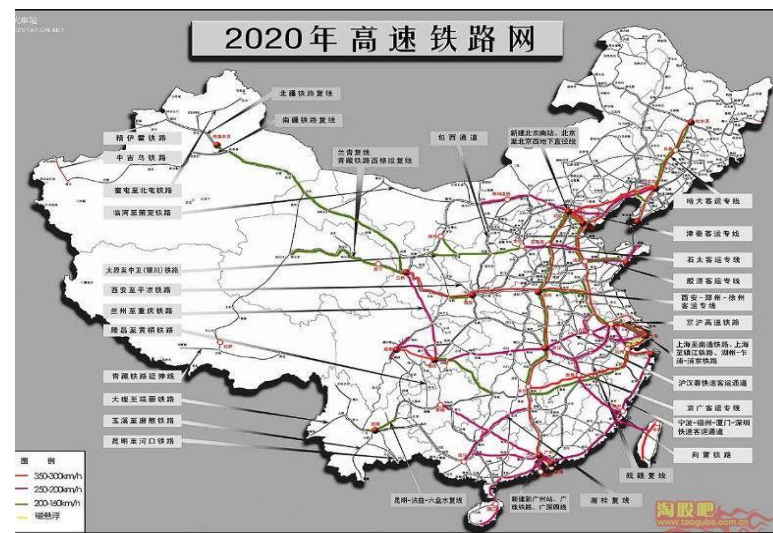
Urbanisation will continue driving fast investment; we will not have a 25% y/y investment, but an around 20% y/y growth by 2015 can still be obtainable

- China has planned to urbanize the whole nation through a “Two Rows Three Column” strategy by connecting major regions within which cities and townships are clustered.
- Target 2015: 42 transportation hubs; 45 thousand km of railways to serve cities with 500k population , 83 thousand highways to serve cities with 200k people; 82 new airports built (to 230 by 2015), covering 80% of population

China's city clusters by 2020

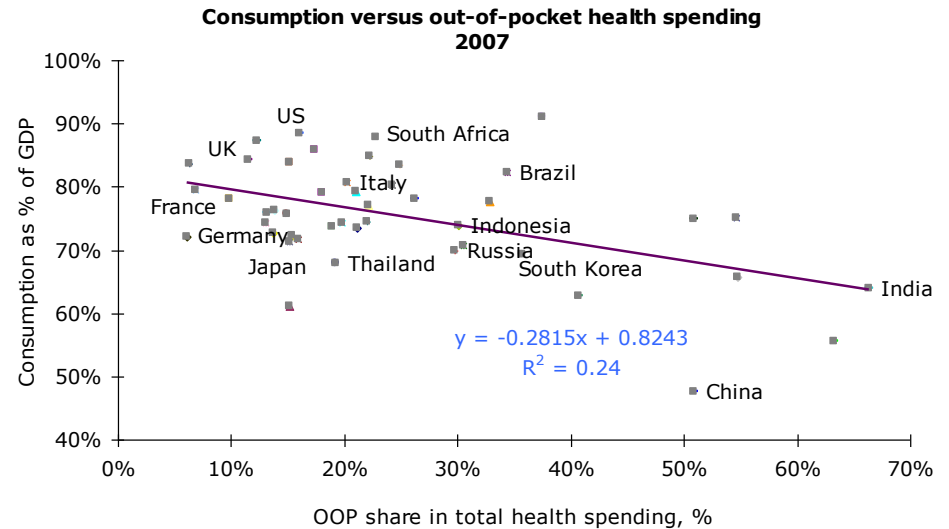
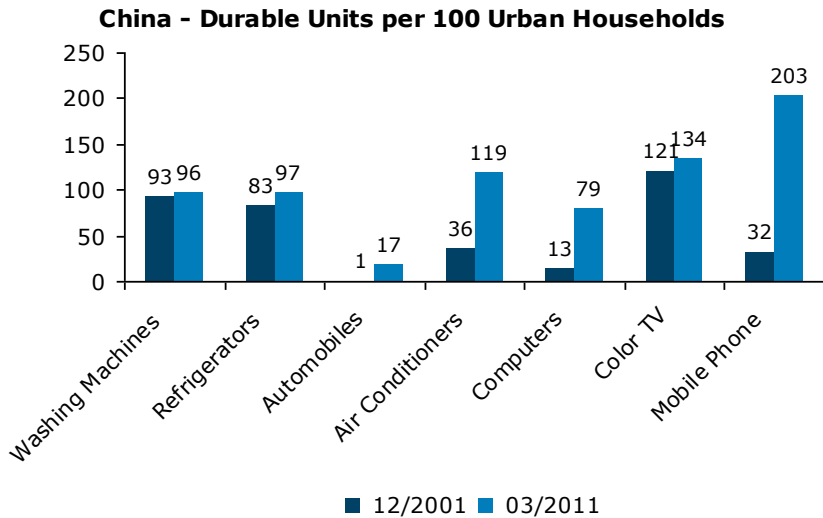
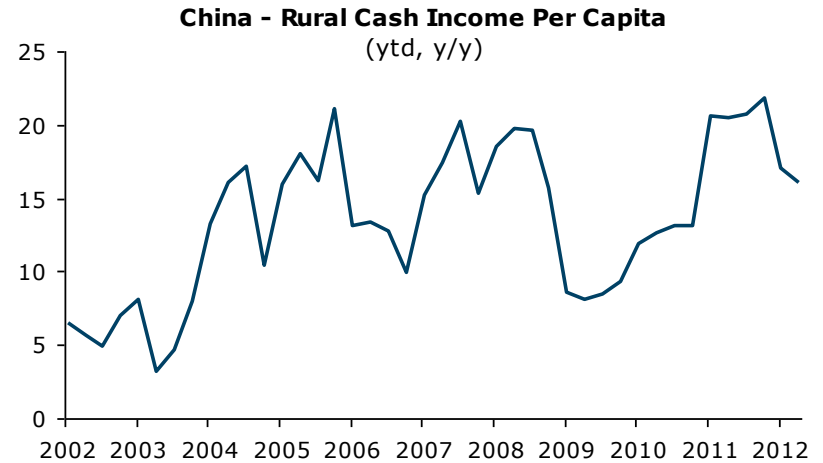


China's high speed rail network by 2020



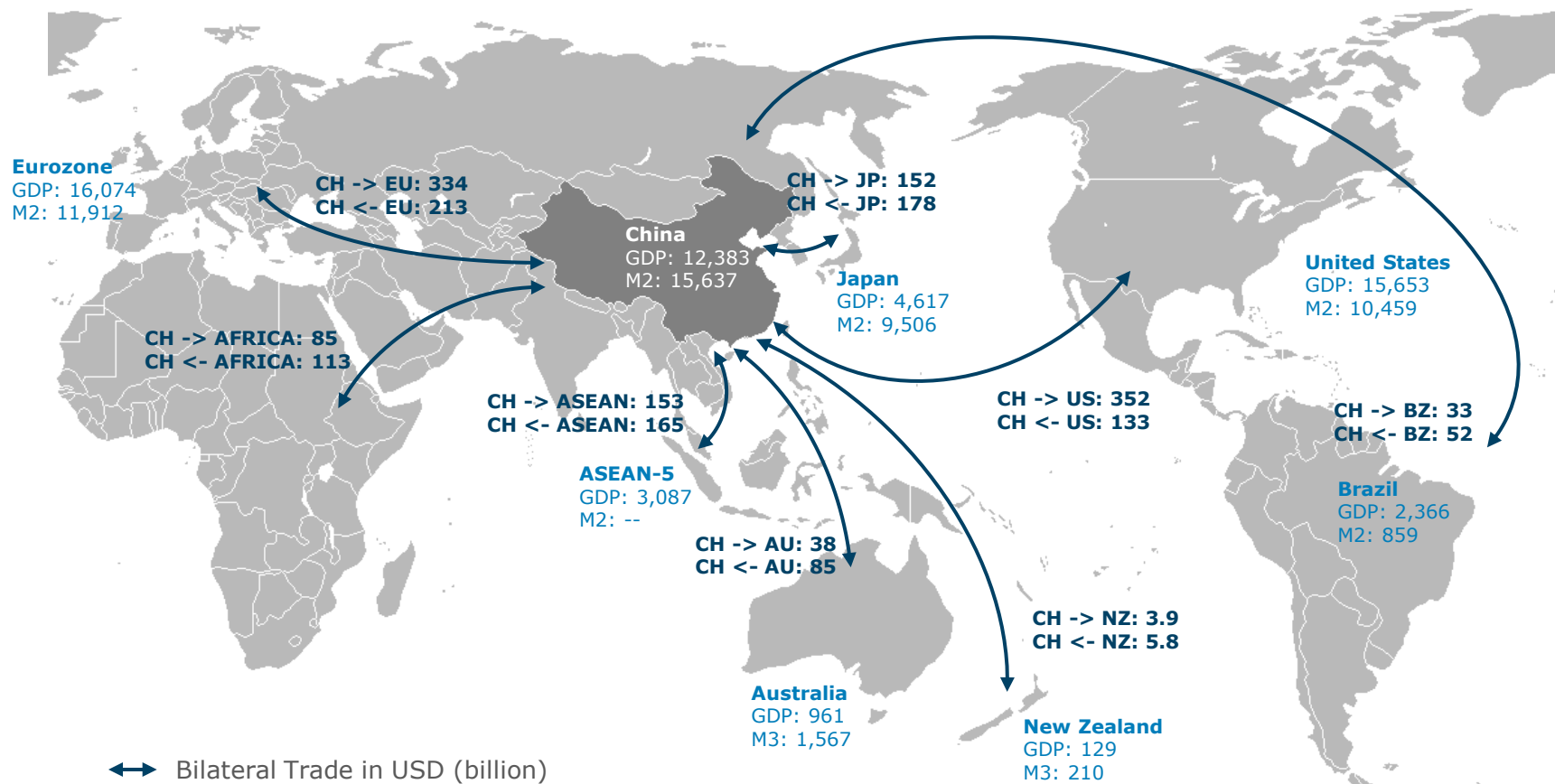
Consumption to hold up solidly on rising wages and social protection

We project total consumption (household+govt) could rise to 52% of GDP by 2015



Encouraging RMB's Use in China's Trade with Key Partners

RMB's eventual global use is a compelling story



GDP figures are IMF's 2012 estimates based on purchasing power parity

M2 and M3 figures are denominated in USD (billion)

Source: IMF, China General Administration of Customs, Bloomberg, CEIC, ANZ Research

2003

- Dec: The PBOC appointed a clearing bank for personal RMB business in Hong Kong. Hong Kong residents can open RMB accounts.

2005

- Jul: RMB exchange rate reform began.
- Sep: Hong Kong RMB business expanded. Designated merchants engaging in tourism and consumer services can open RMB deposits and convert RMB receipts into HKD; current account is allowed for Hong Kong residents who are subject to a daily remittance limit of RMB80,000 and conversion limit of RMB20,000.
- Nov: Hong Kong launched retail RMB non-deliverable forwards.

2007

- Jul: First offshore issuance of RMB bonds by China Development Bank.

2009

- Jan: The PBOC and HKMA signed Currency Swap Agreement (3 years, RMB200bn/HKD227bn)
- Jul: China piloted RMB cross border trade settlements in four cities. Enterprises in the relevant Mainland provinces and cities can settle their merchandise imports, service trades and other current account transactions in RMB, while an expanded list of eligible enterprises were able to settle their merchandise exports in RMB.

2010

- Aug: RMB trade settlement expanded to cover 20 provinces and cities.
- Dec: Hong Kong RMB clearing platform to conduct cash notes business for Taiwan.
- Jan: The Clearing Bank and Participating Banks of RMB Business in Hong Kong can conduct trading in the Mainland's interbank bond market upon approval by the PBOC.
- Dec: HKMA regulated RMB banking activities including the introduction of net open position and 3-month requirement for trade settlements.

- Jan: The PBOC introduced overseas direct investments in RMB.
- Apr: First RMB equity IPO in Hong Kong Exchange by Huixian REIT.
- Jun: Hong Kong Treasury Market Association launched offshore RMB fixing.
- Aug: China's Vice Premier Li Keqiang announced a series of measures to support Hong Kong's offshore RMB centre. The MOF tendered 3-, 5-, 7-, 10-year RMB sovereign bonds in Hong Kong. Cross-border trade settlement scheme was expanded to the whole country.
- Oct: China launched RMB Foreign Direct Investment Programme.
- Dec: First batch of RMB Qualified Foreign Institutional Investor (RQFII) scheme was announced.

- Jan: China's National Reform and Development Commission approved Shanghai's plan to be global RMB centre by 2015.
- Mar: China removed the MDE requirement that had limited certain exporters' participation in RMB trade settlements.
- Mar: HKMA, BNM and Euroclear Bank piloted platform for cross-border investment and settlement of debt securities.
- Mar: China and Australia signed a bilateral currency swap agreement.
- May: Hong Kong and London held a joint private-sector forum to enhance their linkages in the RMB market, specifically regarding clearing and settlement systems, market liquidity and the development of new RMB denominated financial products.
- Jun: HKMA launched RMB liquidity facilities to local banks and removed NOP requirements.
- Jun: Shanghai and Tokyo launched direct JPYCN conversion and quotation
- Aug: Non-Hong Kong residents can open personal RMB accounts in Hong Kong.
- Aug: Taiwan and the Mainland central banks signed an MOU on RMB clearing in Taipei and Shanghai.
- Sep: HKEX launched CNH futures on a deliverable basis.
- Dec: Detailed regulation governing Qianhai-Hong Kong RMB lending flows released.
- Dec: Bank of China Taipei Branch was appointed as RMB clearing bank

Many more in the pipeline

China's RMB capital account to basically convertible by 2015

2013 - 2015

2011

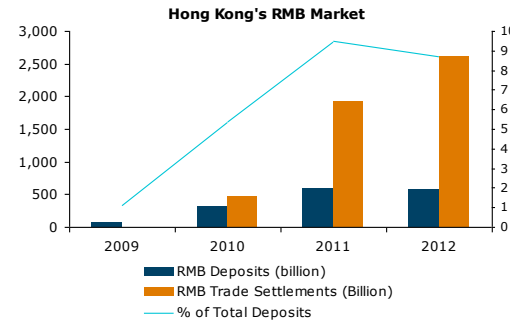
2012

The CNH Market: State of Affairs and the Path of Development

London

- Total RMB deposits reached RMB 14bn in H1 2012
- Spot RMB forex grew to an average daily volume of US\$ 1.7bn
- The volume in letters of credit grew 20 times to RMB 3.7bn
- The City of London initiative was formally launched in April 2012.
- Established a seamless services via RTGS with Hong Kong desks
- RMB bonds are issued frequently

Hong Kong: China's preferred testing ground for a market-based RMB under the National 12th Five Year Plan. Total deposits reached RMB624bn in January 2013.



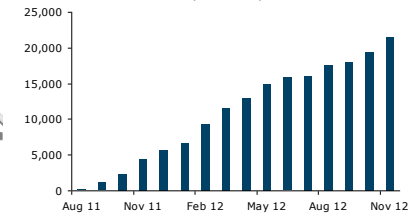
Japan

Yen-Yuan direct trading launched in Shanghai and Tokyo in June

Taiwan:

RMB clearing is available in 2013

Taiwan - OBU RMB Deposits
(RMB million)



Singapore

Issued full banking licences to two Chinese banks in 2012
RMB banking services available at institutional and retail level

RMB as trade currency

Promote RMB reciprocal capital flows

RMB to become convertible

Australia/New Zealand

RBA and NZRB signed bilateral currency swap agreements with the PBoC in 2011 and 2012
RBA set up a joint forum with HKMA for RMB business cooperation

2011 2012 2013 2014 2015

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