

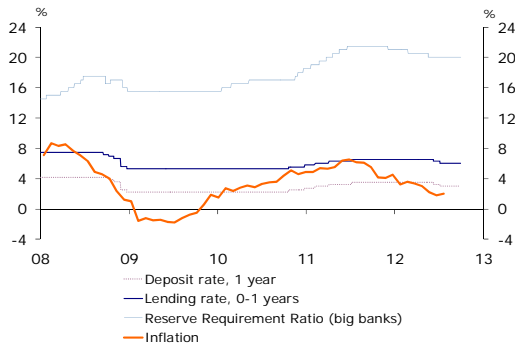
Outlook 2013: China

Growth expected to accelerate again

Weakened external demand and only limited growth supporting policies from the Chinese government were the main factors explaining China's slowing growth rate in the first three quarters of 2012. Growth is expected to accelerate again

in the last quarter of this year and in 2013, albeit only mildly. This outlook, however, is susceptible to many external and domestic uncertainties.

Figure 1: Only limited monetary easing in 2012



Source: Reuters EcoWin

2012 – Has the growth slowdown bottomed out?

China's growth rate has been slowing in the past quarters as a result of strong external headwinds and only limited policy easing and stimulus action by the Chinese government. We must remember that back in late 2010 and in 2011, China's economic policies were aimed at slowing down the economy, as economic overheating was perceived as the main risk at

the time. Monetary policies were tightened throughout 2011 as a result, including five 25bps benchmark interest rate hikes, and no less than nine 50bps increases of the reserve requirement ratio (RRR) (see figure 1). Inflation peaked at 6.5% mid-2011, well above the central bank's 4% target, and remained stubbornly high in the months thereafter. Monetary policies were, therefore, still tight in the first half of 2012, aimed at slowing inflation.

Inflation fell below the 4% target in February 2012 and continued to ease. However, policy easing remained limited. The government was careful not to overstimulate the economy again, as the 2009 round of stimulus had serious adverse secondary effects. Inflation rose rapidly at that time and proved difficult to contain, the real estate sector overheated, local government debt shot up and banks were saddled up with a significant amount of bad debt, as the stimulus program was largely financed by commercial bank debt.

Monetary policy easing was restricted to 'fine-tuning' only. The reserve requirement ratio (RRR) was cut three times to a still high 20% for large banks, down from 21.5%. In June and July 2012, the benchmark interest rates were cut to 6% for loans up to 1 year and 3% for 1 year deposits, down from 6.56% and 3.5% respectively (see figure 1). Fiscal support was marginal, amounting to tax breaks for small-and-medium-sized enterprises and lower taxes on environmentally friendly consumer durables.

In addition, the investment stimulus response from the government was smaller than expected in 2012. A repeat of the massive 2009 stimulus program was not anticipated. However, even with this in mind, the government's response was

Outlook 2013: China

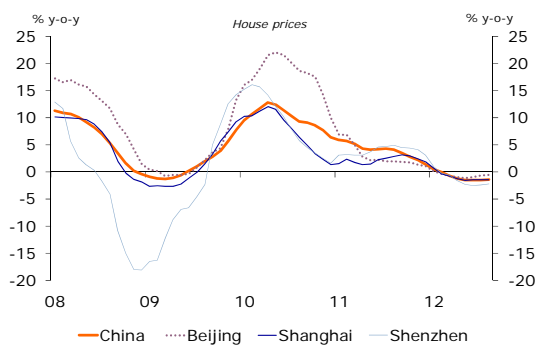
smaller than expected. Around CNY 1,000bn (EUR 125bn) in new, mainly infrastructure projects has been approved so far. This is only about 25% of the roughly CNY 4,000bn in stimulus implemented during the 2008/2009 economic slowdown. On the one hand, this is positive, as a feared increase of longer-term risks has thus, so far, been largely avoided. However, on the other hand, short-term growth continued to slow.

Furthermore, the measures implemented in 2010 and 2011 to cool the overheating real estate sector remain in place. The measures have been successful in achieving their goal: an orderly deflation of the housing bubble. Real estate prices were first curbed before starting to decrease in the first half of 2012 (see figure 2). However, the government rightfully fears the sector will overheat again if real estate measures are relaxed. Real estate investments have been restrained as a result of the measures, especially the speculative kind. Given the direct and indirect importance of the real estate sector to the overall economy, an important growth driver thus remains in the doldrums.

Finally, the external environment also weakened substantially, mainly on the back of the weak performance of the eurozone economies, which are adversely affected by the sovereign debt crisis in the eurozone periphery, and lackluster performance in the US. The slowdown of external demand is adversely affecting the Chinese economy, with especially small-and-medium sized manufactures taking a hit. In September, export growth unexpectedly accelerated to 9.9% y/y, up from 2.7% y/y in August, on the back of strengthened demand from emerging markets in Asia. However, export growth is very volatile and September's export growth can still be considered weak when compared to September 2011, when exports grew by 17% y/y.

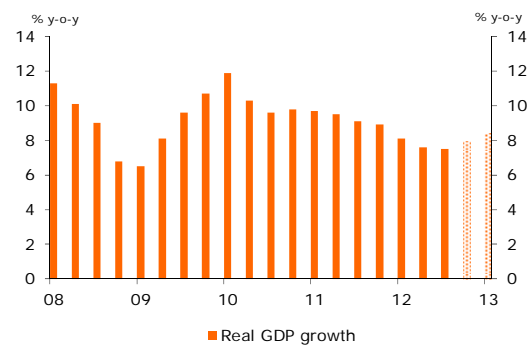
As a result of the abovementioned factors, real GDP has slowed further in the first three quarters of 2012. Real GDP expanded by 8.1% in the first quarter, but

Figure 2: Real estate market cools



Source: Reuters EcoWin

Figure 3: Growth expected to accelerate slightly in 4Q2012

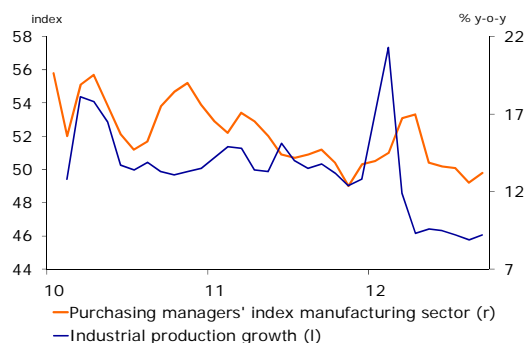


Source: Reuters EcoWin

Outlook 2013: China

fell below 8% in the second quarter, slowing to 7.6% y/y. In the third quarter real GDP growth slowed further and even fell below the government's official growth target of 7.5%, at 7.4% y/y (see figure 3).

Figure 4: Some small positive signs have become visible in the data



Source: Reuters, EcoWin

The main question is whether the growth slowdown has now bottomed out. We do not expect any significant further policy easing or economic stimulus in the fourth quarter. Top officials of the Chinese Communist Party and the Chinese government will be fully focused on the 18th National People's Congress - start date: November 8th - and the subsequent leadership transition. The congress will start-off a once-in-a-decade power changeover within the Communist Party and the Chinese government. After the new leadership has been 'elected', it will take at least until early 2013 before they are well and truly settled into their new positions. Therefore, it will likely remain relatively quiet regarding major stimulus actions or major policy easing.

However, first indications that the steps that have already been taken will start to have a positive effect on economic growth in the fourth quarter have become visible in the data. The most recent purchasing managers' indices (PMI's) show improved confidence in the economy, with especially the large state-owned enterprises being upbeat. Furthermore, increased investment, mostly in infrastructure as a result of the government speeding-up its projects approval process, is starting to show in the figures. Railway investments stand out in particular, increasing by a staggering 111% in September compared to a year earlier. Industrial production growth, which has slowed significantly in 2012, also seems to have stabilized and even recovered slightly in September (see figure 4). These positive signs indicate that growth is likely to accelerate again in the last quarter, with full year growth estimated at around 7.8% in 2012.

2013 – Growth expected to accelerate, albeit only slightly.

Forecasting China's economic performance in 2013 is somewhat more of a challenge, as it will depend on factors that are difficult to predict.

First of all, the performance of the external sector. If demand from Europe and the US would pick up, this would significantly boost growth in China. However, although global growth will recover somewhat in 2013, it is expected to remain relatively subdued. The developments in the eurozone will be a key determinant in this respect, but are very difficult to predict and subject to substantial downside risks. The outlook for China's export performance is thus uncertain.

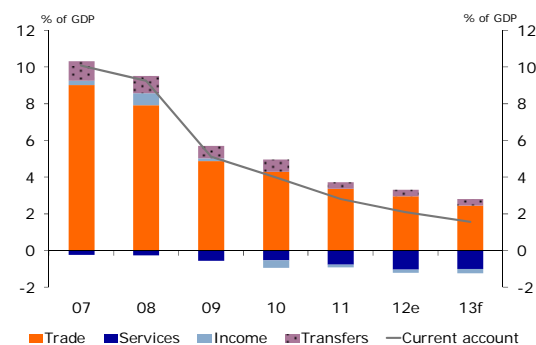
Outlook 2013: China

Assuming no major developments (i.e. no major breakthrough nor a major break down) in the eurozone, we do not expect that export growth will be a major growth-driving factor next year. With import growth likely to increase on the back of a stronger domestic economy, China's trade and current account surpluses will expectedly narrow. The trade surplus is estimated to narrow from around 3% of GDP in 2012 to an estimated 2.5% of GDP in 2013, reducing the current account surplus to roughly 1.6% of GDP in 2013, down from 2.1% in 2012 (see figure 5).

Secondly, domestic policy adjustments and stimulus efforts will continue to be a key factor in determining China's growth prospects but have become more difficult to predict. The approach to economic stimulus or policy easing under President Hu Jintao and premier Wen Jiabao's administration is different today than it was a few years ago. Moreover, future policies will be implemented by a new group of leaders, almost certain to be headed by Xi Jinping (president) and Li Keqiang (premier).

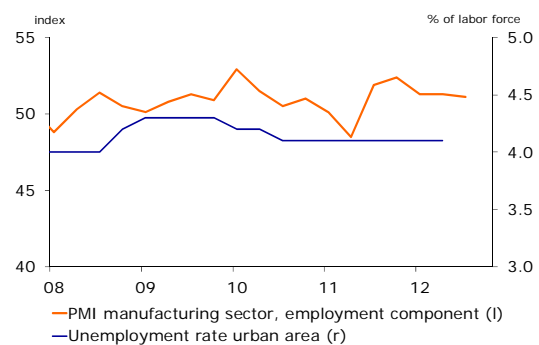
Although a major change of policy focus is not anticipated, it remains to be seen what the position of these new leaders will be with regard to issues such as government driven investment stimulus and the real estate sector measures. It is more likely than not that the (new) government will continue on the prudent path set out by the Hu/Wen administration in 2012. Not only has the government learned from past mistakes and will remain careful not to overstimulate the economy. There is also less urgency to boost economic growth this time, as employment, a key determinant of government policies, has so far proved to be resilient. In spite of economic growth slowing down, the unemployment rate has remained stable. In addition, the employment component in PMIs has declined only slightly and seems to have stabilized (see figure 6). As long as employment remains resilient, the government will accept relatively slow economic growth.

Figure 5: Current account surpluses will narrow



Source: EIU

Figure 6: Employment has been resilient so far



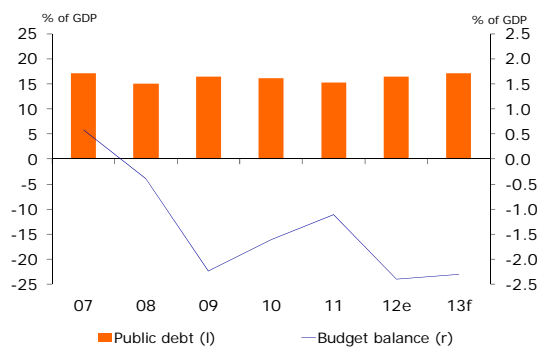
Source: EIU, Reuters EcoWin

Outlook 2013: China

The new administration, we expect, will therefore wait and see how much more stimulus and policy easing will be required to maintain sufficient employment growth, and act only as far as needed. With inflationary pressures expected to

rise to an average of around 4% in 2013 on the back of utility price reforms, slightly increased economic activity and higher input prices, this is a sensible approach in spite of the risk of running behind the curve if developments disappoint strongly.

Figure 7: Government finances in good shape



Source: EIU

If needed, however, the Chinese government has sufficient financial room to implement further economic stimulus if it wants to. The government's budget deficit is relatively small at around 2.4% of GDP while the government's debt stock is low at around 17% of GDP (see figure 7). It could, as it has done before, speed up investments scheduled in the

current 5-year plan. Although the government has the means to finance these directly, financing investments with commercial banks loans, as it has done in the past, would likely be the preferred approach.

In addition, the real estate measures could be eased. With pent-up demand for real estate present, this would provide a quick and strong boost of the economy. However, any major easing of these measures will only be taken in an extremely negative scenario, as they strongly increase risks in the longer term. However, some tailor-made easing of real estate measures in areas that have been less affected by real estate bubble formation is a possibility. In addition to inflationary pressures, more investment stimulus would increase risks to the banking sector in the medium-term, as it would likely add to the bad debt related problems already affecting the banking sector as a result of the 2009 stimulus program. The risk of a real estate bubble would increase sharply if the real estate measures are eased significantly.

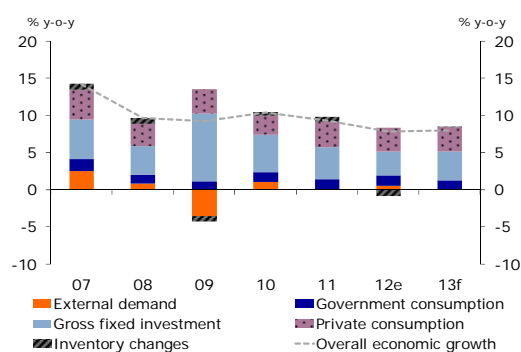
Significant further monetary easing is less likely, though. Deposit rates cannot be lowered much further without having a negative effect on the amount of deposits placed at banks, which, given the restrictive loan-to-deposit ratio of 75% that Chinese banks have to adhere to, are vital to fund credit growth. Lowering lending rates further without reducing deposit rates would hurt bank margins, which are badly needed to allow banks to continue to build up capital that they will need to deal with an anticipated increase of bad debt in the coming years. In addition, lower lending rates will also provide a boost to the real estate market, which the government is trying to cool down.

Outlook 2013: China

Taking the factors mentioned above into account, we expect the Chinese economy to grow by between 7.5% and 8.5% in 2013 (see figure 8), depending on the strength of global demand, the effect of the policy easing and stimulus

measures already taken and the extent to which the (new) government will implement stimulus measures or policy easing.

Figure 8: GDP growth will recover slightly in 2013



Source: EIU

Downside risks that may affect growth in 2013 are a weaker than expected external environment and, on the domestic front, stress in the banking sector and rising inflation. Regarding the external environment, developments in the eurozone and the US will be chief.

Domestically, stress in the banking sector could result from rising non-performing loans. Repayment of the commercial bank loans used to finance the 2009 stimulus effort is being jeopardized by the weakening financial

position of local governments, and slower economic activity, which hurts the creditworthiness of creditors in general. Higher than expected inflation could result from higher international commodity prices, increased credit growth or weather induced food price volatility. This would, in turn, reduce the scope for government stimulus and could force the government to take actions that would slow down the economy, such as monetary tightening.

On the upside, a solution to the eurozone problems, or stronger than expected growth in the US would greatly benefit China's economic performance next year. Should the Chinese government opt to provide more stimulus to the economy, or ease monetary, fiscal and/or real estate policies, this would enhance the 2013 growth prospects, but at the cost of increased longer-term risks.

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
<i>Key country risk indicators</i>							
GDP (% real change pa)	14.2	9.6	9.2	10.4	9.3	7.8	8.0
Consumer prices (average % change pa)	4.8	5.9	-0.7	3.2	5.5	3.1	5.0
Current account balance (% of GDP)	10.1	9.2	5.1	4.0	2.8	2.1	1.6
Total foreign exchange reserves (m USD)	1530283	1949261	2416041	2866079	3202789	3538750	3809540
<i>Economic policy</i>							
Budget balance (% of GDP)	0.6	-0.4	-2.2	-1.6	-1.1	-2.4	-2.3
Public debt (% of GDP)	17	15	16	16	15	17	17
Exchange rate LCU to USD (average)	7.6	6.9	6.8	6.8	6.5	6.3	6.3
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	9.0	7.9	4.9	4.3	3.4	3.0	2.5
Current account balance (% of GDP)	10.1	9.2	5.1	4.0	2.8	2.1	1.6
Inward FDI (% of GDP)	4.5	3.8	2.2	4.1	3.1	2.4	2.3
Foreign debt (% of GDP)	11	8	8	9	9	9	9
FX-reserves import cover (months)	17.8	19.0	26.0	22.6	20.2	20.7	19.7
Liquidity ratio	250	259	288	258	239	237	230

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