UBS 瑞银

Global Economics Research

China

Hong Kong

UBS Investment Research

China Focus

Growth Slows. What Next?

15 July 2010

www.ubssecurities.com

Tao Wang
Economist
S1460208080042
wang.tao@ubssecurities.com
+8610-5832 8922

China's GDP growth slowed to 10.3% (y/y) in Q2 2010, as the slowdown in stimulus-related investment growth led to a deceleration in heavy industry production. We expect GDP growth to slow to about 8-8.5% in Q4 2010 as the impact of the property tightening measures becomes more apparent. Annual GDP growth in 2010 is expected to be 9.5-10%, and 8.7% in 2011.

CPI inflation unexpectedly dropped to 2.9% in June, as the reported cost of residence stopped rising, and that of clothing and transport dropped from last month. We expect CPI inflation to climb above 3% again in the next couple of months, but maintain our annual CPI inflation forecast of 3%, as the government is likely to delay energy and resource price hikes further.

The strong recovery in exports has more than offset the slowdown in investment. We expect export growth to slow from 40%+ to less than 10% in Q4, but upgrade our annual export growth forecast to 24%, and trade surplus to $185 billion. This is supportive of our view that CNY/USD will strengthen by about 4% this year.

As worries of overheating 3 months ago turned into concerns of a hard landing on balance, we think the government will maintain the current macro policy stance, with no rate hike this year or additional property tightening measures. The next noticeable policy move is likely to be announcement of new investment programs for next year and beyond, in the context of regional and industrial rebalancing.

Table 1: GDP growth forecast

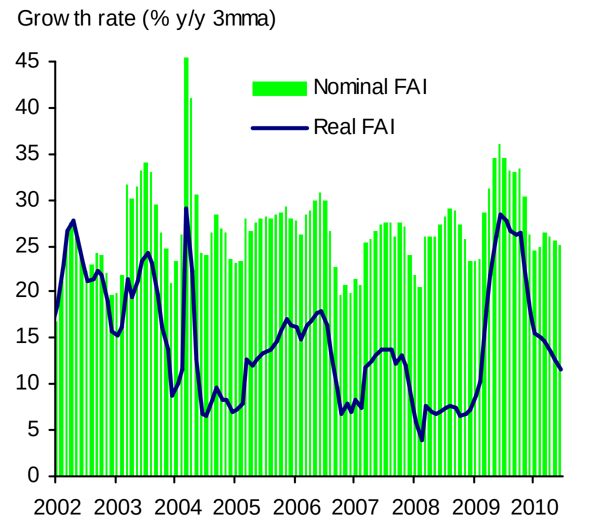
% change	2009	2010E	2011E	Quarterly	2009				2010			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3E	Q4E
y/y	9.1	9.5-10	8.7	y/y	6.5	8.1	9.4	11.5	11.9	10.3	9.4	8.2
				q/q (saar)	7.7	14.9	11.9	11.7	9.2	8.6	8.0	7.2

Source: NBS, CEIC, UBS estimates

Growth outlook: soft landing

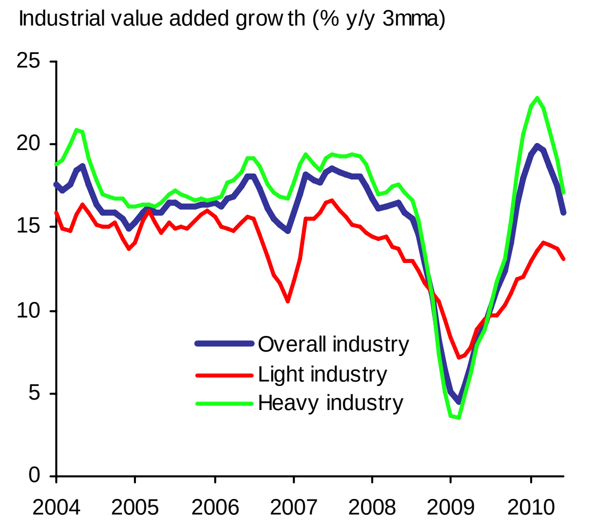
China's GDP growth slowed to 10.3% (y/y) in Q2 2010, as the slowdown in stimulus-related investment growth led to a deceleration in heavy industry production (Chart 1-2). Given the change in base effect, the slowdown is largely expected. We expect GDP growth to slow to about 8~8.5% in Q4 2010 as the impact of the property tightening measures becomes more apparent (Table 1). Annual GDP growth in 2010 is expected to be 9.5-10%, and 8.7% in 2011.

Chart 1: Investment led the slowdown



Source: NBS, CEIC, UBS estimates

Chart 2: Heavy industry production is decelerating fast

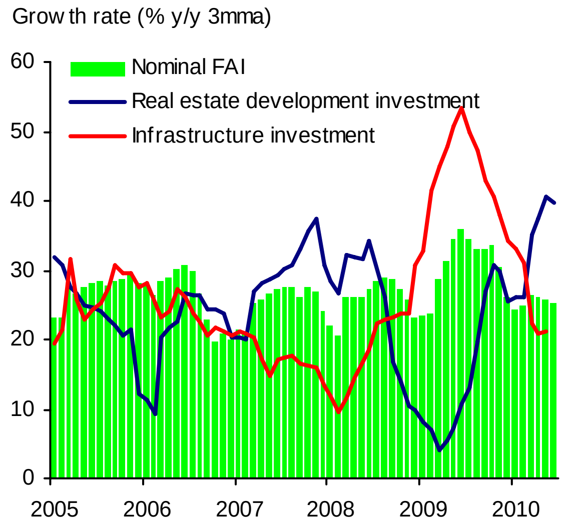


Source: NBS, CEIC, UBS estimates

Within fixed investment, the obvious slowdown in infrastructure investment has been partially offset by the rising real estate investment so far this year, while manufacturing investment has also started to recover (Chart 3-4). Going forward, we expect property investment to slow as weak sales and stagnant prices lead to a drop in housing starts and slowdown in construction. As we have stated numerous times before, the deceleration in property construction will lead to a drop in demand for commodities and construction materials later in the year, bringing down heavy industrial production further (see "*Property Construction and Exports, Both Heading South*", 13 July 2010, and "*China Property Data: A Desired Outcome?*", 10 June 2010)

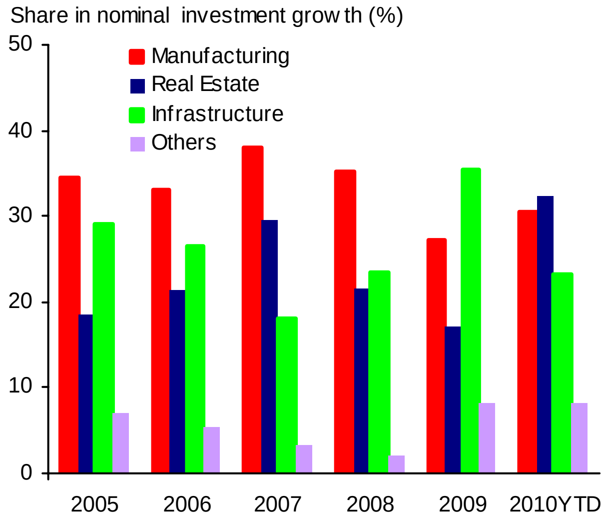
While we expect economic growth to "soft land", the downside risk mainly comes from two fronts: a double-dip in the developed economies; and the steeper-than-expected slowdown in China's heavy industrial sector – from weaker-than expected property construction and more closure of energy-inefficient plants. If the two factors overlap, GDP growth could be below 8% in either Q4 2010 or Q1 2011.

Chart 3: The offsetting factors



Source: NBS, CEIC, UBS estimates

Chart 4: Manufacturing investment is recovering



Source: NBS, CEIC, UBS estimates

Inflation forecast: achieving the "magical" 3%

We have maintained from the beginning of this year that CPI inflation is not a big concern and that it is going to average at about 3% in 2010. Nevertheless, the drop of June CPI inflation to 2.9% was unexpected. Food prices dropped m/m as some seasonal and one-off factors faded, and that is expected. Prices of core manufacturing goods such as clothing and durable goods stayed flat or declined, underscoring our belief that existing output gap in global economy will keep core inflation subdued. Residence prices (which include rent, utilities, renovation materials and housing costs) stopped rising m/m, which is somewhat surprising.

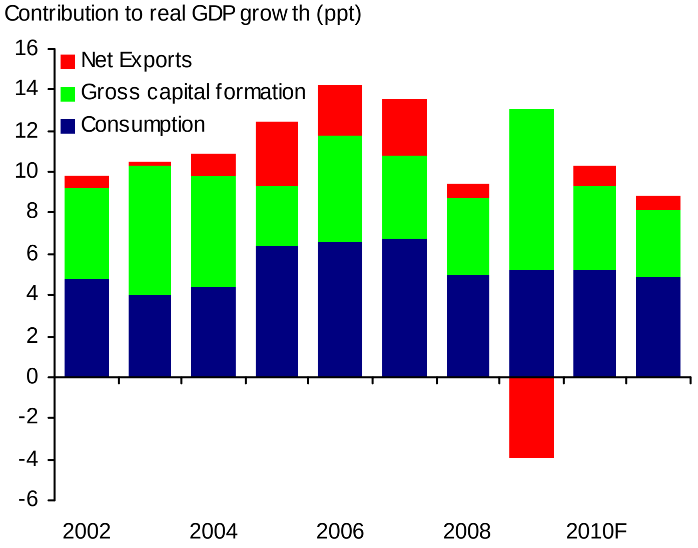
We expect CPI inflation to climb above 3% again in the next couple of months before it slows again at the end of 2010. This is based on our assumption that the government will continue to control new bank credit at 7.5 trillion this year and will delay energy and resource price hikes further until 2011. We maintain our annual CPI inflation forecast of 3% for 2010, and revise down our 2011 inflation forecast to 3.5%.

Trade forecast: return of the export engine?

On the back of the strong export growth so far, we upgrade our export growth for 2010 to 24% (from 18%). Exports grew by 43.9 percent in USD terms in June and have outpaced imports in recent months. As a result, trade surplus rebounded from 14.3 billion in Q1 to 41.2 billion in Q2. Excluding the price impact, we expect net exports to contribute to 1 percentage point of GDP growth in 2010, a huge turnaround compared to the -4 percentage points in 2009 (Chart 5).

Does this mean that China's export engine is back to full steam and can we expect its trade surplus returning to a rising trend as a share of GDP? No. It is true that that the strong recovery in exports has more than offset the slowdown in investment this year. But we expect export growth to slow to less than 10% in Q4 (and possibly zero in December), as base effect fades and as the rebound in export demand weakens. Over the medium term, we see the contribution of net exports to GDP growth dropping to zero, even as trade surplus stay substantial in absolute terms (Table 2). This is supportive of our view that CNY/USD will strengthen by about 4% this year and 3-5% a year in the next couple of years.

Chart 5: The export-turnaround offsets the investment slowdown



Source: CEIC, UBS estimates

Table 2: Trade and Current Account forecasts

	2008	**2009**	**2010**	**2011**
	actual	actual	**forecast**	forecast
Exports of goods (%, in USD)	17.2	-16.1	**24.0**	12.0
Imports of goods (%, in USD)	18.5	-11.2	**30.0**	12.0
Trade surplus (Customs, USD billion)	298.1	195.7	**184.0**	206.0
Current account (USD billion)	436.1	297.1	**320.6**	361.4
Current account (% of GDP)	9.6	6.0	**5.6**	5.3

Source: CEIC, UBS estimates

Macro policy: Relaxing or further tightening?

As economic growth slowed, the worries about overheating and asset bubbles have declined, but fresh concerns about a hard landing increased. While some believe more tightening measures are necessary to bring down housing prices, others call for a new stimulus or a relaxation in macro policy to avoid a "double dip" in China's economy. The latter group of people may consider 8% GDP growth as too low and sub-8 percent growth as a recession.

We see the ongoing deceleration of economic activity as still consistent with a soft-landing scenario, and expect the government to maintain the current macro policy stance for at least the next few months. For policy makers, GDP growth of 11% (H1 2010) and export growth of 40%+ hardly warrants a relaxation of policy or fresh stimulus.

On the property sector, policy makers are likely to wait to see the full impact of the ongoing measures before implementing new policies or changing course. We do not expect property tax to be unveiled any time soon.

On monetary policy, we expect (i) no change in this year's credit target (RMB7.5 trillion new loans, 18% growth); (ii) no rate hike in 2010; possible rate hike starting in Q2 2011; and (iii) no RRR hike in the short term, an increased use of central bank bills to sterilize inflows of foreign exchange, which is expected to increase again in the coming year.

On fiscal policy: The ongoing clean up of local government investment vehicles is critical to contain fiscal and banking sectors risks over the medium term. However, this does not mean that government stimulus-projects launched in the past 18 months will not be supported. Moreover, the "exit" from the RMB 4 trillion-stimulus will only be gradual – which means budget deficit will likely be kept above 2% of GDP in 2011. In the Chinese context, this is considered a "proactive" fiscal stance, even though the fiscal impulse could be negative. We also expect new investment programs in the context of balancing regional growth and/or developing new strategic industries to be announced for implementation in 2011 and beyond, which could be seen as a continuation of the stimulus.

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by UBS Securities Co. Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request.

Company Disclosures

Issuer Name
China (Peoples Republic of)

Source: UBS; as of 15 Jul 2010.

Global Disclaimer

This report has been prepared by UBS Securities Co. Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS. In certain countries, UBS AG is referred to as UBS SA.

This report is for distribution only under such circumstances as may be permitted by applicable law. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation. It is published solely for information purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments in any jurisdiction. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning UBS AG, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. UBS does not undertake that investors will obtain profits, nor will it share with investors any investment profits nor accept any liability for any investment losses. Investments involve risks and investors should exercise prudence in making their investment decisions. The report should not be regarded by recipients as a substitute for the exercise of their own judgement. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS as a result of using different assumptions and criteria. Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. UBS is under no obligation to update or keep current the information contained herein. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this report is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates and other market conditions. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither UBS nor any of its affiliates, nor any of UBS' or any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC and/or UBS Capital Markets LP) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this research report. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein.

Any prices stated in this report are for information purposes only and do not represent valuations for individual securities or other instruments. There is no representation that any transaction can or could have been effected at those prices and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions, by UBS or any other source, may yield substantially different results.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is communicated by UBS Limited, a subsidiary of UBS AG, to persons who are eligible counterparties or professional clients and is only available to such persons. The information contained herein does not apply to, and should not be relied upon by, retail clients. UBS Limited is authorised and regulated by the Financial Services Authority (FSA). UBS research complies with all the FSA requirements and laws concerning disclosures and these are indicated on the research where applicable. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France SA. UBS Securities France S.A. is regulated by the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this report, the report is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:** Prepared by UBS Menkul Degerler AS on behalf of and distributed by UBS Limited. **Russia:** Prepared and distributed by UBS Securities CJSC. **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A.. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this report, the report is also deemed to have been prepared by UBS Italia Sim S.p.A.. **South Africa:** UBS South Africa (Pty) Limited (Registration No. 1995/011140/07) is a member of the JSE Limited, the South African Futures Exchange and the Bond Exchange of South Africa. UBS South Africa (Pty) Limited is an authorised Financial Services Provider. Details of its postal and physical address and a list of its directors are available on request or may be accessed at http:www.ubs.co.za. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a **'non-US affiliate'**), to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a report prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this report must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. **Canada:** Distributed by UBS Securities Canada Inc., a subsidiary of UBS AG and a member of the principal Canadian stock exchanges & CIPF. A statement of its financial condition and a list of its directors and senior officers will be provided upon request. **Hong Kong:** Distributed by UBS Securities Asia Limited. **Singapore:** Distributed by UBS Securities Pte. Ltd or UBS AG, Singapore Branch. **Japan:** Distributed by UBS Securities Japan Ltd to institutional investors only. Where this report has been prepared by UBS Securities Japan Ltd, UBS Securities Japan Ltd is the author, publisher and distributor of the report. **Australia:** Distributed by UBS AG (Holder of Australian Financial Services License No. 231087) and UBS Securities Australia Ltd (Holder of Australian Financial Services License No. 231098) only to 'Wholesale' clients as defined by s761G of the Corporations Act 2001. **New Zealand:** Distributed by UBS New Zealand Ltd. An investment adviser and investment broker disclosure statement is available on request and free of charge by writing to PO Box 45, Auckland, NZ. **Dubai:** The research prepared and distributed by UBS AG Dubai Branch, is intended for Professional Clients only and is not for further distribution within the United Arab Emirates.

The disclosures contained in research reports produced by UBS Limited shall be governed by and construed in accordance with English law.

UBS specifically prohibits the redistribution of this material in whole or in part without the written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. Images may depict objects or elements which are protected by third party copyright, trademarks and other intellectual property rights. © UBS 2010. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

UBS