

# CHINA ECONOMIC MONITOR

Treasury Division



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## Hard Landing Risk Low and Inflation Peaking, but a New Challenge Emerges

- Mainland China's economy continued to grow impressively by 9.5% in the second quarter of 2011 after increasing 9.7% in the first quarter on the back of strong domestic demand and the return of a trade surplus, easing concern of a hard landing.
- Looking ahead, external demand will remain weak for an extended period due to the fragile recovery in the US and the ongoing fiscal tightening in Europe. As such, domestic demand will continue to be the main growth driver. We expect the Mainland's economic growth to moderate to 9.0% in the second half and average 9.3% for the whole year.
- The Mainland's consumer price inflation surged further to a three-year high of 6.4% in June due mainly to soaring food prices. However, inflation is likely to have peaked during June or July and should start to trend lower in coming months barring further supply shocks. We expect the full-year consumer price inflation to average 4.8%. As such, the government is likely to be close to the end of its tightening cycle. We expect the government to hike interest rates only one more time by 25 basis points, and raise banks' required reserve ratio by another 0.5 percentage point in the rest of this year.
- Local governments debt (LGD), amounting to RMB10.7 trillion or equivalent to 27% of last year's GDP, poses a fresh challenge to the authorities. Almost 80% of the debt was loans from banks. With 41% of the debt due in 2011 and 2012, repayment pressure is particularly high this year and next. But the LGD problem is unlikely to pose a serious risk to the banking sector given the authorities' vigilance over the issue and the strong fiscal position of the central government.

**Exhibit 1: Economic Forecast**

% year on year	2009	2010	2011F
Real GDP	9.1	10.3	9.3
Fixed asset investment (real)	33.7	20.2	17.0
Retail sales (real)	16.9	14.8	13.0
RMB loans outstanding	31.7	19.9	15.7
Consumer prices	-0.7	3.3	4.8
Exports	-16.0	31.3	18.0
RMB per US dollar	6.83	6.62	6.30

Sources: National Bureau of Statistics of China; Hang Seng Bank



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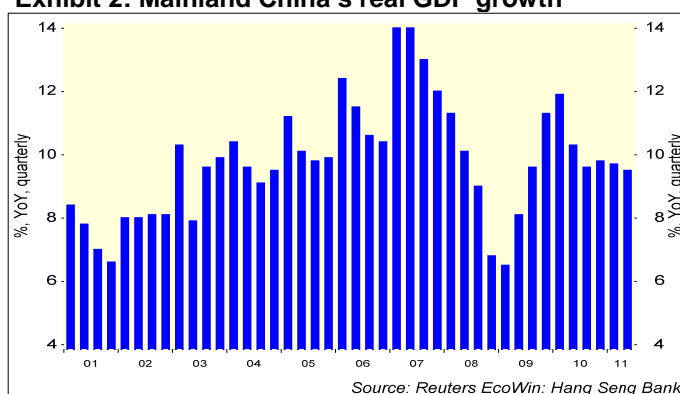
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## Economy continued to grow impressively in the second quarter

Mainland China's economy continued to grow impressively by 9.5%<sup>1</sup> in the second quarter of 2011 after increasing 9.7% in the first quarter on the back of strong domestic demand and widening trade surplus (Exhibit 2), easing concern of a hard landing of the Mainland economy. In the first half of this year, real GDP grew 9.6%.

**Exhibit 2: Mainland China's real GDP growth**



In the second quarter, fixed asset investment (FAI) in urban areas remained strong, climbing 25.9% after advancing 25.0% in the first. Retail sales of consumer goods also held up well on steady income growth, rising 17.3% and 16.3% in the corresponding periods. In real terms, personal income gained 7.6% in urban areas and 13.7% in rural areas in the first half of this year.

Although export growth moderated to 22.1% in the second quarter from 26.5% in the first, import growth slowed even faster to 23.1% from 32.7% in the same period, resulting in a trade surplus of US\$46.0 billion in the second quarter compared with a trade deficit of US\$1.0 billion in the first.

A breakdown of the GDP components showed that consumption and investment were still the key growth drivers, contributing a total 9.2 percentage points to the second quarter's economic growth (Exhibit 3). Contribution from net exports of goods and services also became positive, accounting for the remaining 0.3 percentage point to the overall real GDP growth.

**Exhibit 3: Contribution to mainland China's real GDP growth (percentage points)**

	2010	1Q 2011	2Q 2011*	1H 2011
Consumption (household + government)	3.9	5.9	3.3	4.6
Investment (private + public)	5.6	4.3	5.9	5.1
Net exports of goods & services	0.8	-0.5	0.3	-0.1
<b>Real GDP growth %</b>	<b>10.3</b>	<b>9.7</b>	<b>9.5</b>	<b>9.6</b>

Source: CEIC; National Statistical Bureau; Hang Seng Bank  
\*HASE estimate

<sup>1</sup> All growth rates are year-on-year unless specified otherwise



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## Export growth to slow further in the second half

Though Mainland China's economic growth in the second quarter of 2011 was stronger than expected, it is likely to moderate in the second half due to the government's tightening monetary policy and the fragile global economic prospects.

We expect mainland China's export growth to slow further in the second half on falling momentum of the US economic recovery and fiscal tightening in Europe. In the US, high unemployment and falling home prices are weighing on consumer spending, which account for 70% of the US economy. In Europe, many countries are tightening their belts in an effort to reduce their debts and deficits.

The growth of exports to major economies has already slowed in the first half of 2011. As shown in Exhibit 4, both the growth of exports to the European Union (EU) and the US were far below the overall export growth of 24%. Exports to the EU, the Mainland's biggest export market, only rose 16.9% in the first half of 2011 after increasing 31.7% in 2010, suggesting that fiscal tightening in European countries has begun to take its toll on the region's import demand. Similarly, the growth of exports to US, the second biggest market, also decelerated to 16.9% from 28.3% during the same period.

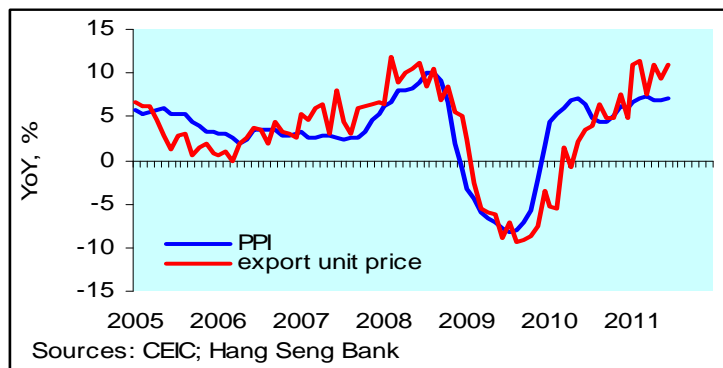
**Exhibit 4: Mainland's exports by major markets in Jan-Jun 2011**

	Exports (US\$ billion)	Growth (% yoy)	Share of total (%)
EU	164.5	16.9	18.8
USA	145.5	16.9	16.6
Hong Kong SAR	127.0	35.9	14.5
Asean	80.1	24.0	9.2
Japan	68.2	23.7	7.8
Other	289.0	27.5	33.1
<b>All</b>	<b>874.3</b>	<b>24.0</b>	<b>100.0</b>

Sources: China Customs; Hang Seng Bank

One consolation to Mainland exporters is that export unit prices are rising faster than producer prices in recent months after falling behind for a year, which should help offset some of the recent increases in wages and other costs. Export unit price rose 10.2% in the first half of this year, compared with a 7% increase in producer prices in the same period (Exhibit 5).

**Exhibit 5: Mainland China's producer prices and export unit price**



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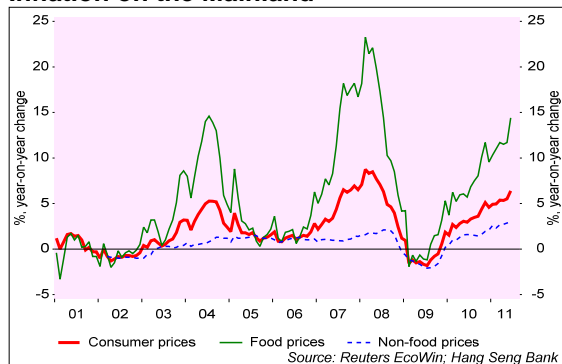


Overall, mainland China's exports are projected to increase by about 18% this year, after climbing 31.3% in 2010. With export growth slowing, domestic demand will continue to be the main growth driver of the Mainland's economy in the rest of this year. We expect that Mainland's economic growth would moderate to 9.0% in the second half of this year from 9.6% in the first. For the full year, we maintain our forecast that the Mainland economy would grow 9.3% in 2011.

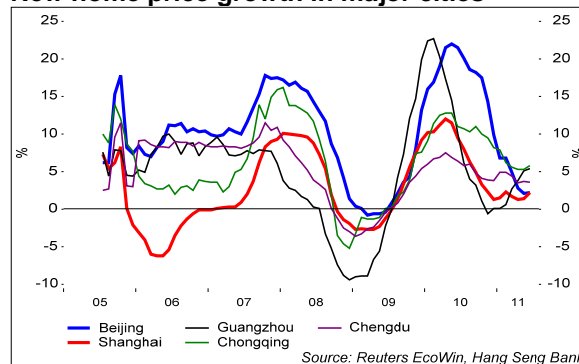
## Inflation to Trend Lower

Inflation has been the main concern for the Mainland economy but price pressures seem to be easing. Consumer price inflation shot up to a three-year high of 6.4% in June from 5.5% in May and 5.3% in April due mainly to soaring food prices, though non-food prices also gained significance (Exhibit 6). In June, food prices surged 14.4% after increasing 11.7% in May and 11.5% in April, while non-food prices grew 3.0%, up from increases of 2.9% and 2.7% in the same period. For the second quarter of 2011, consumer price inflation climbed 5.7%, up from 5.0% in the first. In addition, home prices continued to trend higher in the second quarter of 2011 (Exhibit 7), especially in smaller cities outside the coastal areas.

**Exhibit 6:**  
**Inflation on the Mainland**



**Exhibit 7:**  
**New home price growth in major cities**



With inflation and home prices still rising, the People's Bank of China (PBOC), the Mainland's central bank, continued to tighten monetary policy. The latest tightening move was the 25bp increase in interest rates, effective July 7. The PBOC has hiked interest rates three times and raised banks' reserve requirement ratios (RRR) six times since the start of the year. The one-year benchmark deposit and lending rates are now 3.5% and 6.56% respectively, and the RRR is 21.5% for large banks and 19.5% for small and mid-sized ones (Exhibits 8 and 9).

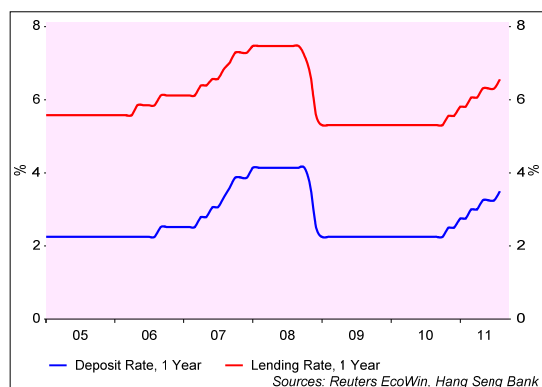


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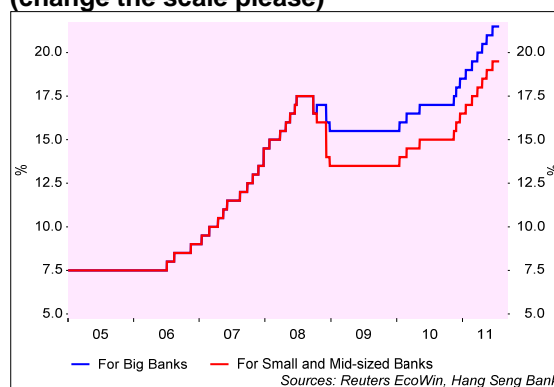
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**Exhibit 8: China's loan and deposit rates**



**Exhibit 9: China's RRR for commercial banks (change the scale please)**



Looking ahead, however, inflation is likely to have peaked during June or July and should start to trend lower in the second half of this year barring further supply shocks. We expect the full-year consumer price inflation to average 4.8%.

Against such a background, the PBOC is likely to be close to the end of its tightening cycle. We expect the PBOC to hike interest rates only one more time by 25 basis points, and raise RRR by another 0.5 percentage point in coming months. By the end of the year, the one-year loan rate would be 6.81% and the RRR for large banks would be 22.0%.

## A new challenge in the form of local government debt

Inflation risk may be lower, but Mainland policymakers are confronted with another challenge, in the form of local government debt. According to the Mainland's National Audit Office (NAO), local government debt amounted to RMB10.7 trillion at the end of 2010, equivalent to 27% of GDP (Exhibit 10). About half of the total debt was raised through local government financing vehicles.

**Exhibit 10: Local government debt at the end of 2010**

	Total	Borrowed	Guaranteed	Local government related institutions
Local government debt (RMB trillion)	10.7	6.7	2.3	1.7
- financing vehicles	5.0	3.1	0.8	1.0
Local government debt (% GDP)	27.0	16.9	5.8	4.3
- financing vehicles	12.5	7.9	2.1	2.5

Source: National Audit Office; Hang Seng Bank



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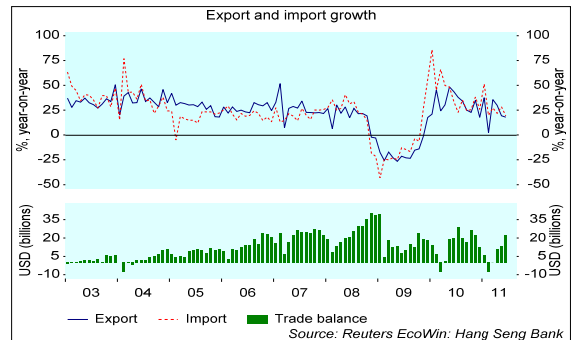
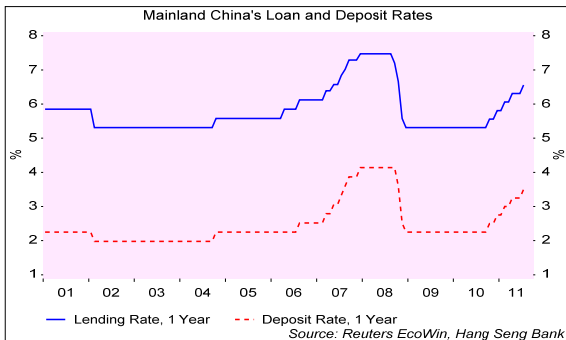
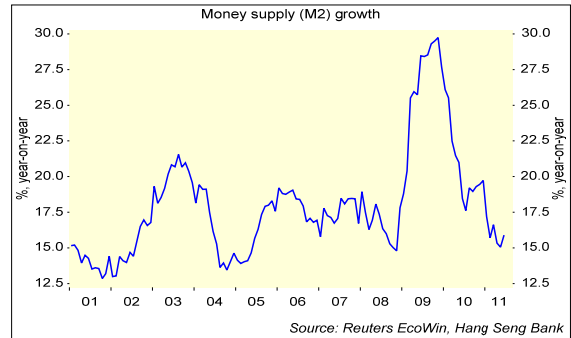
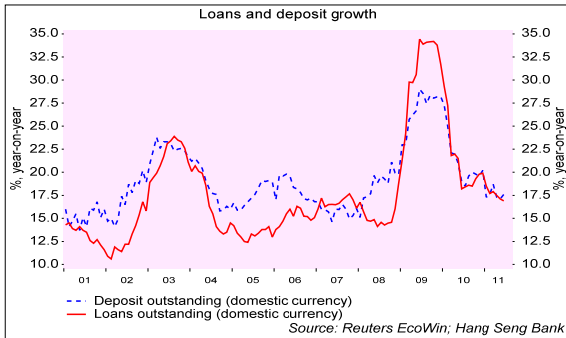
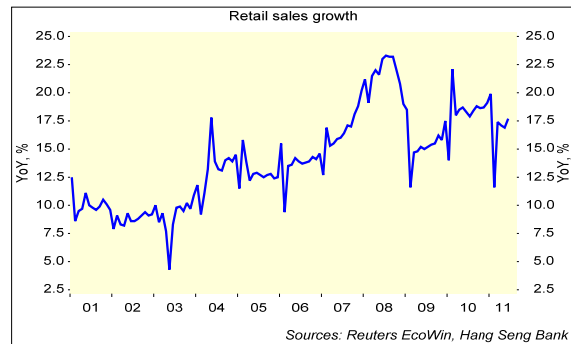
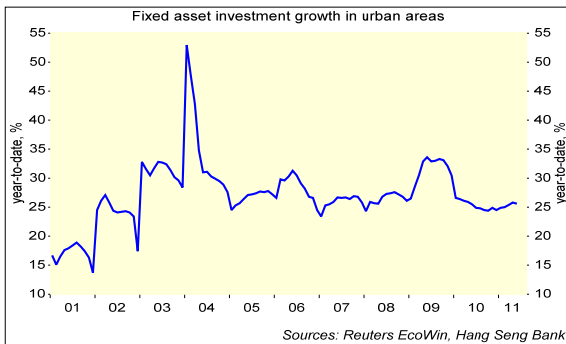
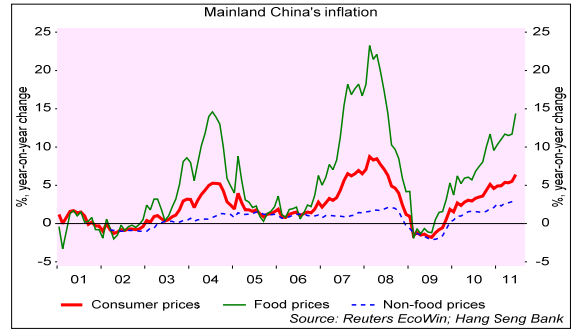
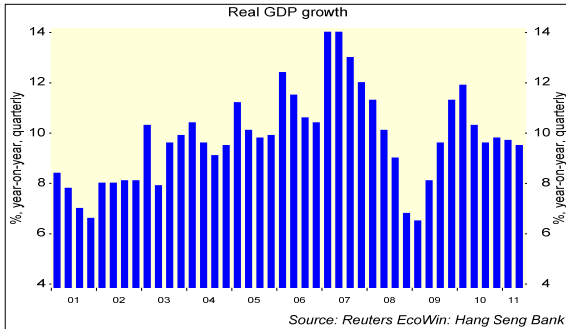
According to the NAO, RMB8.5 trillion or 79% of local governments' total debt outstanding were loans from banks, accounting for 18% of banks' total RMB loans outstanding. In addition, with RMB4.5 trillion or 41% of the total local government debt due in 2011 and 2012, repayment pressure is particularly high this year and next.

However, the problem is unlikely to pose serious risk to the Mainland economy for a number of reasons. Firstly, the problem has been identified and officials are taking measures to contain new local government borrowing and mitigate the risks. In addition, the central government is in a strong position fiscally and the banking sector is relatively healthy after many years of strong growth. Given the Mainland's strong growth prospects, the local government debt problem is unlikely to cause fiscal stress or pose a serious risk to the banking sector.



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China Economic Monitor Statistics

August 2011



	GDP		Industrial output*	Fixed asset investment**		Retail sales		Foreign trade					Consumer prices		
	Nominal RMB bn	real growth yoy(%)	real growth yoy(%)	growth, yoy, %		growth, yoy, %		Exports		Imports		Trade balance US\$bn	yoy(%)	Food yoy(%)	non-food yoy(%)
				nominal	real	nominal	real	nominal	real	nominal	real				
2006	21,631	12.7	16.6	24.5	22.7	13.7	12.6	27.2	24.0	20.0	16.8	177.5	1.5	2.3	1.0
2007	26,581	14.2	18.5	25.8	21.5	16.8	12.5	25.7	19.1	20.8	13.4	262.2	4.8	12.4	1.0
2008	31,405	9.6	12.9	26.6	16.3	21.6	14.8	17.5	8.1	18.5	3.2	295.5	5.9	14.6	1.6
2009	34,051	9.2	11.0	30.5	33.7	15.5	16.9	-16.0	-10.6	-11.2	3.1	196.1	-0.7	0.8	-1.4
2010	39,798	10.3	15.7	24.5	20.2	18.4	14.8	31.3	28.5	38.7	22.0	183.1	3.3	7.2	1.4
2011F	46,320	9.3	13.0	23.0	17.0	17.5	13.0	18.0	14.0	22.0	13.0	160	4.8	9.6	2.8
2012F	53,500	9.0	12.0	21.0	16.0	18.0	14.0	18.0	13.5	20.0	11.0	155	3.5	5.0	2.8
Q4	10,937	11.4	18.0	24.8	26.0	16.6	16.7	0.2	7.3	22.3	25.1	61.5	0.7	3.4	-0.7
Q1 2010	8,162	11.9	19.6	26.4	24.0	17.9	15.4	28.7	33.0	64.6	42.5	14.5	2.2	5.0	0.8
Q2	9,122	10.3	15.9	25.2	20.8	18.5	15.2	40.9	38.7	43.7	21.0	40.8	2.9	5.9	1.5
Q3	9,582	9.6	13.5	23.1	19.0	18.5	15.2	32.3	25.9	27.1	14.5	65.6	3.5	7.4	1.5
Q4	12,932	9.8	13.3	23.9	17.6	18.7	13.9	25.0	18.0	29.4	18.1	62.5	4.7	10.5	1.9
Q1 2011	9,631	9.7	14.4	25.0	17.4	16.3	11.6	26.4	15.0	32.8	15.8	-1.0	5.0	11.0	2.5
Q2	10,815	9.5	13.9	25.9	18.0	17.3	11.6	22.1	10.6	23.1	6.9	46.0	5.7	12.5	2.9
Feb 2011	NA	NA	14.9	NA	NA	11.6	7.0	2.4	(8.1)	19.4	2.4	-7.6	4.9	11.0	2.3
Mar	NA	NA	14.8	25.1	17.5	17.4	12.2	35.8	26.3	27.3	10.2	0.1	5.4	11.7	2.7
Apr	NA	NA	13.4	26.1	18.2	17.1	11.8	29.9	17.1	21.8	7.9	11.4	5.3	11.5	2.7
May	NA	NA	13.3	26.7	18.8	16.9	11.4	19.4	9.1	28.4	10.0	13.1	5.5	11.7	2.9
Jun	NA	NA	15.1	25.1	17.2	17.7	11.2	17.9	6.3	19.3	3.1	22.3	6.4	14.4	3.0
Year-to-date	20,446	9.6	14.3	25.6	17.7	16.8	11.6	24.0	12.5	27.6	11.1	44.9	5.4	11.8	2.7

	Per capita income				Deposits outstanding (domestic currency)#		Loans (domestic currency)#			Lending rate (end-period)	Money supply (M2)	Forex reserves (end-period)	Foreign direct investment	RMB per USD mid-rate (end-period)	New home prices in Shanghai
	Urban		Rural		RMB bn	yoy %	Outstanding		New loans RMB bn	1-year %	yoy(%)	US\$ bn	yoy(%)	yoy(%)	yoy(%)
	RMB	real growth yoy(%)	RMB	real growth yoy(%)			RMB bn	yoy %							
2006	11,760	10.4	4,302	8.2	33,546	16.8	22,535	15.1	3,066	6.12	16.9	1,066	0.4	7.8087	-3.3
2007	13,786	12.2	4,958	9.4	38,937	16.1	26,169	16.1	3,635	7.47	16.7	1,528	14.9	7.3046	3.4
2008	15,781	8.4	5,737	8.6	46,620	19.7	30,340	18.8	4,180	5.31	17.8	1,946	29.7	6.8400	5.6
2009	17,175	9.8	6,270	9.6	59,770	28.2	39,970	31.7	9,590	5.31	27.7	2,399	-13.2	6.8270	1.0
2010	19,109	7.8	7,089	9.1	71,823	20.2	47,920	19.9	7,950	5.81	19.7	2,847	12.4	6.6227	7.4
2011F	21,320	7.0	8,100	9.0	83,315	16.0	55,420	15.7	7,500	6.81	16.0	3,390	10.0	6.30	NA
2012F	23,680	7.0	8,130	8.0	96,645	16.0	62,900	13.5	7,480	6.81	16.0	3,780	10.0	6.00	NA
Q4	4,117	9.9	1,963	10.1	58,390	28.4	39,040	34.2	1,283	5.31	29.3	2,273	-10.7	6.8290	7.4
Q1 2010	5,308	7.5	1,814	9.2	63,820	22.1	42,580	21.8	2,601	5.31	22.5	2,447	-7.7	6.8263	10.6
Q2	4,449	7.6	1,264	10.2	67,410	19.0	44,610	18.2	2,029	5.31	18.5	2,454	31.8	6.7909	11.0
Q3	4,577	7.5	1,791	9.7	70,094	20.0	46,275	18.5	1,676	5.31	19.0	2,648	10.4	6.7011	6.4
Q4	4,775	8.7	2,220	7.6	71,823	20.2	47,920	19.9	1,632	5.81	19.7	2,847	3.6	6.6227	2.3
Q1 2011	5,963	7.1	2,187	14.3	75,280	19.0	49,470	17.9	2,255	6.06	16.6	3,045	29.4	6.5564	1.8
Q2	5,078	8.1	1,519	13.1	78,640	17.6	51,400	16.9	1,925	6.31	15.9	3,198	9.2	6.4716	1.6
Feb 2011	NA	NA	NA	NA	72,590	17.6	48,886	17.7	536	6.06	15.7	2,991	32.2	6.5752	2.3
Mar	NA	NA	NA	NA	75,280	19.0	49,470	17.9	679	6.06	16.6	3,045	32.9	6.5564	1.7
Apr	NA	NA	NA	NA	75,620	17.3	50,210	17.5	740	6.31	15.3	NA	15.2	6.4990	1.3
May	NA	NA	NA	NA	76,730	17.1	50,770	17.1	552	6.31	15.1	NA	13.4	6.4845	1.4
Jun	NA	NA	NA	NA	78,640	17.6	51,400	16.9	634	6.31	15.9	3,198	2.8	6.4716	2.2
Year-to-date	11,041	7.6	3,706	13.7	78,640	17.6	51,400	16.9	4,170	6.31	15.9	3,198	18.4	6.4716	1.7

NA not available; (A)= actual; (e)= HASE estimate; yoy= year-on-year; (1H)= first half

\* Includes output by SOEs and non-SOEs with annual output sales of over RMB5 million. It accounts for about 88% of national industrial output.

\*\*Only covers fixed asset investment in urban areas. It accounts for about 85% of national fixed asset investment

@ Also covers FDI in financial sectors since January 2008

# Accounting for about 95% of total deposits and loans

Source: State Statistical Bureau; China Statistical Yearbook; CEIC







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