

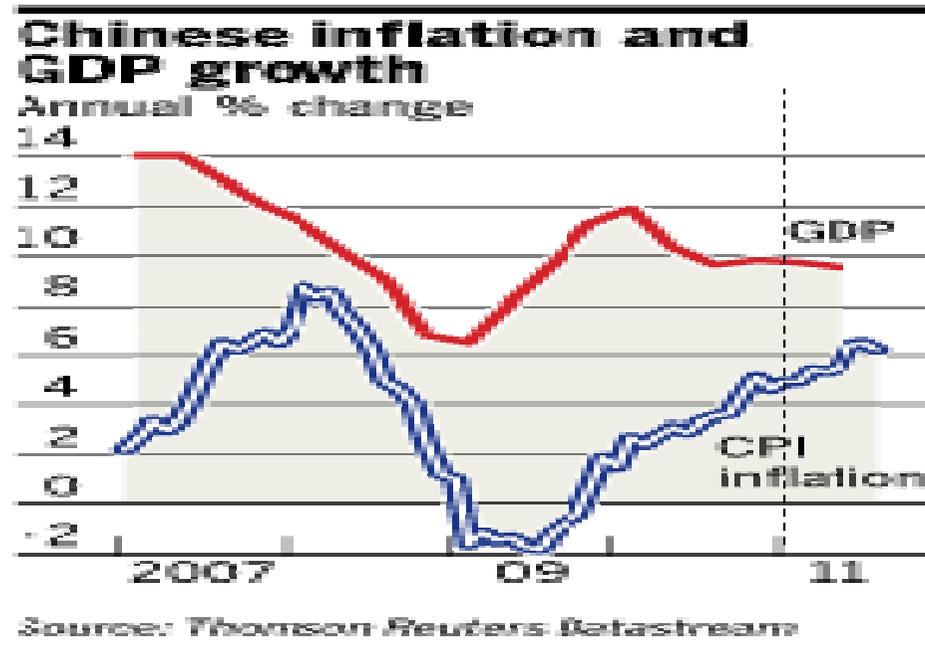
China's macroeconomic situation and policy

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China's macro-situation at the beginning of 2011



2010 growth rate was 10.3%
CPI annual average was 3.3%, in December
4.6%, rising steadily since 2009

Prioritization of macroeconomic policy in 2011

- Contain Inflation
 - >5% aimed at 4% eventually
- Contain real estate bubbles
 - A gradual fall of house prices
- Maintain a decent growth rate
 - In 12th five year plan 7%
 - No clear target for 2011
 - 8-9% should be OK
- Preserve the value of China's foreign assets
 - No specific plan

Performance up to the third quarter

图表1 9月主要宏观经济指标

(同比 %)	7月实际数据	8月实际数据	9月实际数据
GDP	9.7 (一季度)	9.5% (二季度)	9.1% (三季度)
工业增加值	14	13.5	13.8
固定资产投资	25.4	25.0	24.9
社会消费品零售总额	17.2	17.0	17.7

资料来源: CEIC, 瑞穗证券

CPI		6.4	6.2	5.5	4.2
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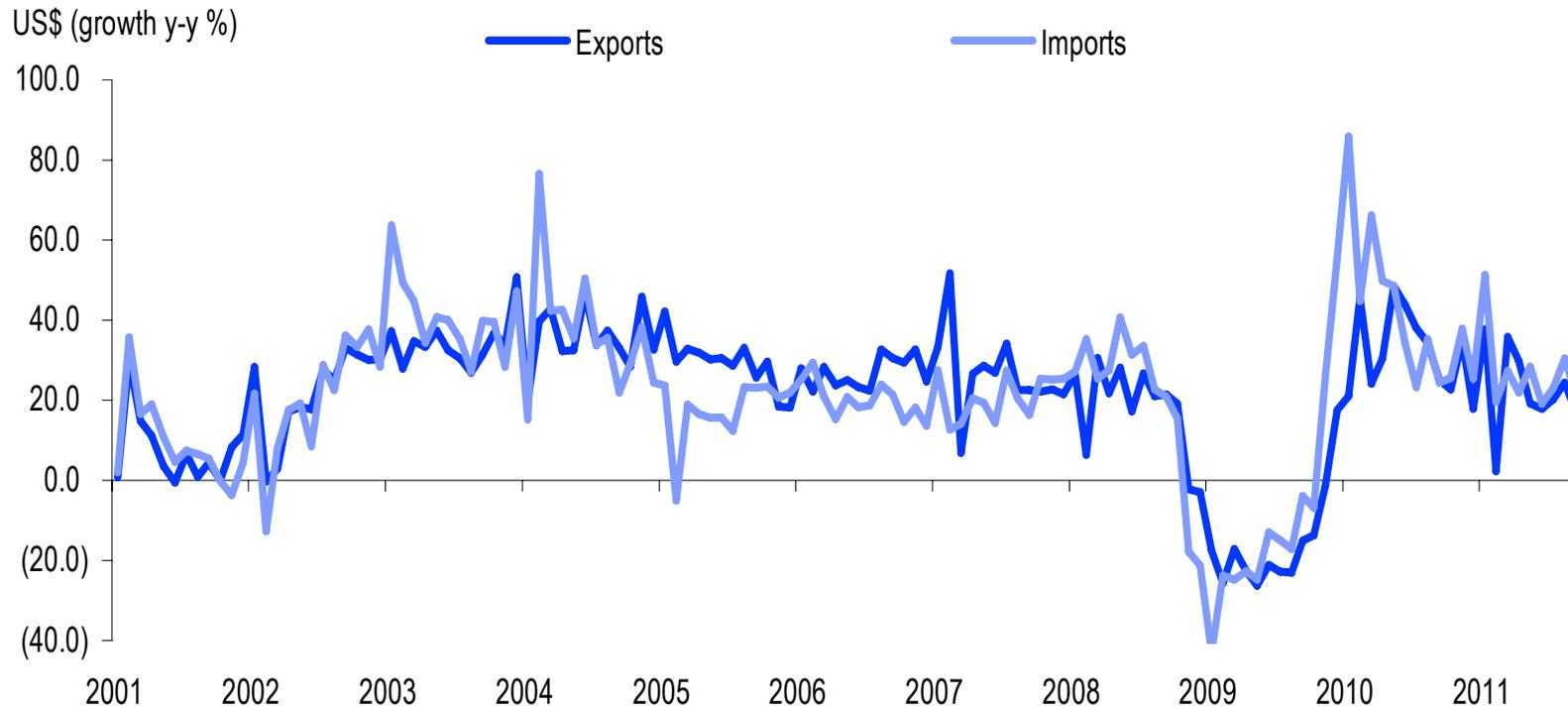
What about housing bubble?

- Data from property consultancy SouFun published Thursday show average prices were down **0.28% month-to-month in November**, the third monthly drop in a row. Many expect bigger price cuts to come. Two-thirds of developers surveyed recently by Standard Chartered expected around a **10% drop in prices in the next six months.**

Challenges laying a head

- A hard landing
 - Export
 - Real estate investment

China's external trade is slowing down



Source: CEIC

Ikujis

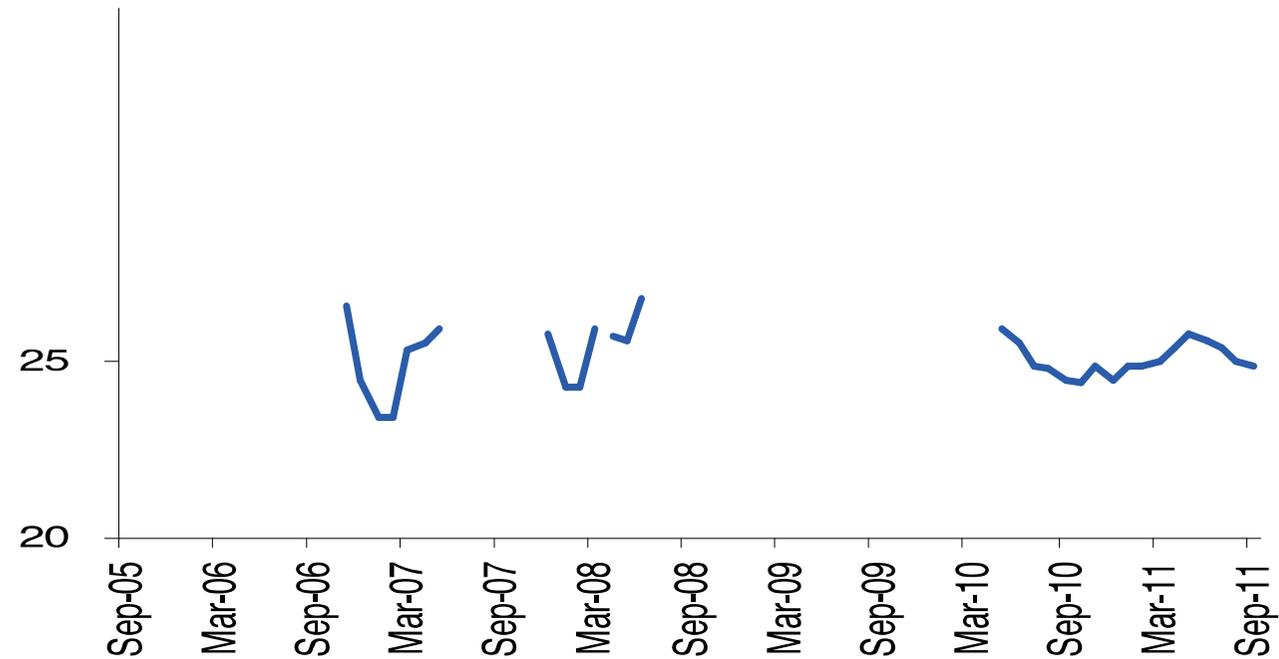
Growth rates of exports and imports were 17.1%
20.9% in Sep. 3 ppercentage lower than in august.
monthly surplus was unchanged at US\$14.5bn in September,

Correlation between China's exports and global growth



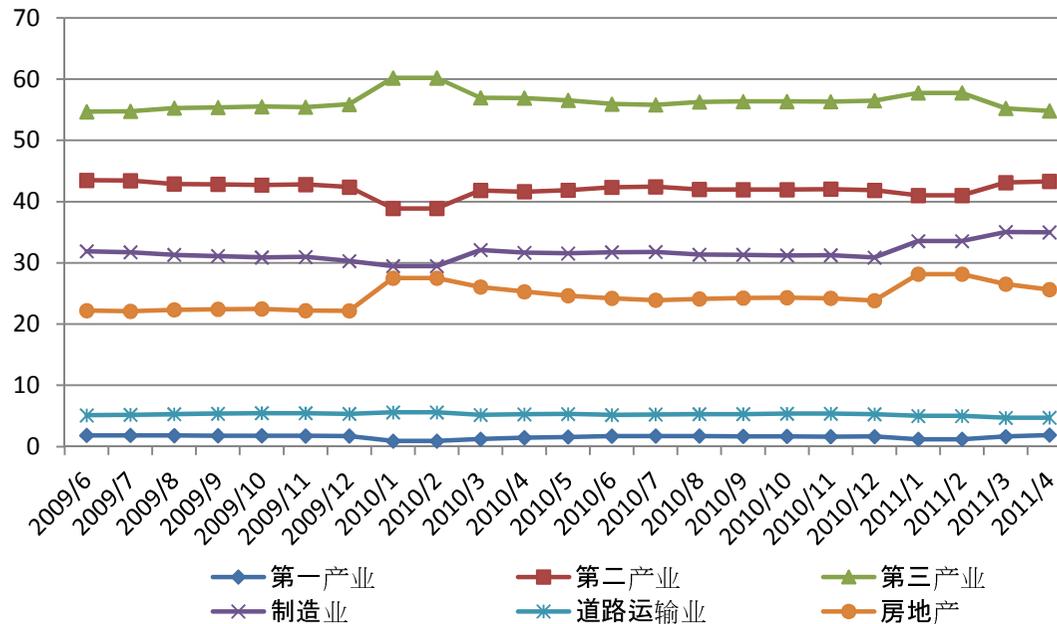
Because the Chinese economy is highly dependent on exports, and exports depends on the world economy, the growth of exports should be moderate in 2011, due to the slowdown of global recovery. **High Elasticity with respect to global growth.**

Fixed asset investment growth



料来源: CEIC, 瑞穗证券

Components of FAI: real estate investment stand out



Real estate: the single most important contributing factor to GCF growth, because it accounts a fourth of GCF).

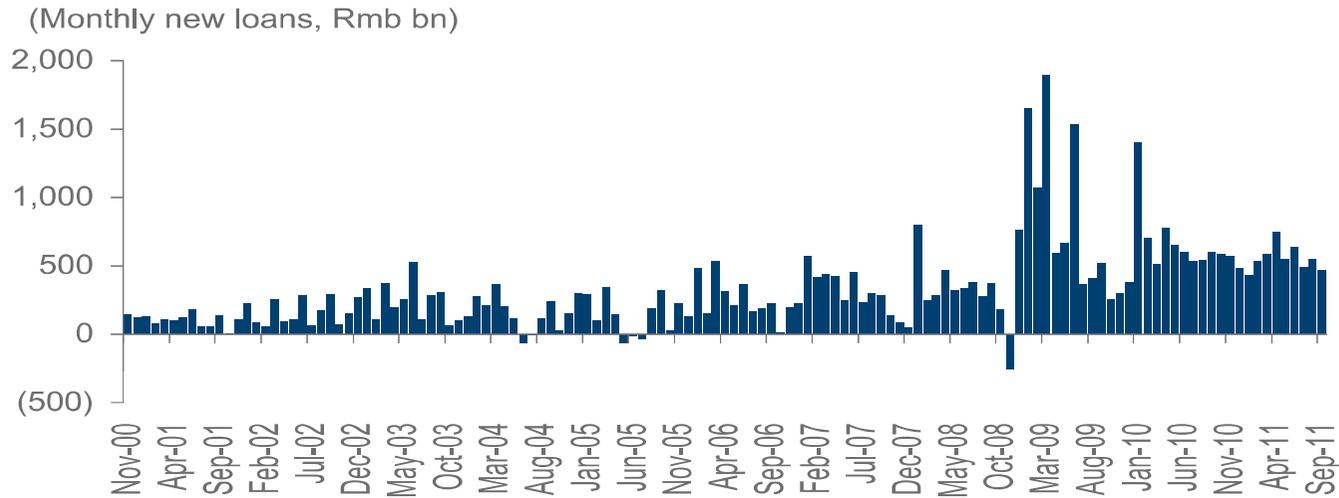
House construction driven economy : 25% and 10%

Instruments of monetary control

- Credit control
- Reserve requirements
 - China raised banks' reserve ratio five times this year. Commercial banks must deposit with the central bank to 21.5 per cent, with effect from June
 - Benchmark interest rates
 - Since April 6, interest rate on one year deposits and loans are raised to 3.25% and 6.31%, respectively
- Central bank bills
- other
 - Say appreciation

Increase in credits since the crisis

■ Monthly new loans are edging down still



Source: CEIC, Daiwa

09 9.6 trillion
10 7.5 trillion
11 7.0 trillion

Growth rates of M1 and M2

■ M1 and M2 growth

(Monthly, YoY %)



Source: CEIC, Daiwa

9月份m2增长速度只有**13%**，同8月相比进一步下降（13.5%）

The direction of China's monetary policy in the near future

- How will China's monetary policy play out?
Will the PBOC tighten more aggressively in the remainder of this year?
- Last week, reserve ratio was lowered by 0.5 percentage to 21%
- Why, what are the implications?

How to understand PBOC's recent lowering reserve requirements

- Outflows let
- Over-tightening in August
- Concerted action with foreign central banks
- brink and chicken-out, wrong signal?
 - Will inflation rebound?
 - Will housing prices resume the trend of rising?
 - Is it too early to cut the reserve ratio?

Three possible triggers of crisis?

- First, China's housing market is on the brink of collapse.
- Second, China's fiscal position will worsen rapidly because of massive local government debt.
- Third, the crash of underground credit networks will lead to a broad financial crisis across the country.

Collapse of housing market?

- the **real demand** for houses will still be strong after the withdrawal of speculative. A **floor for housing prices** will be set
- Quality of mortgages (very high down payments, very low delinquency and default, no securitization)
- Banks are in a position to absorb a large impact
- The real issue (rather than real estate bubble): **resource allocation**
 - most important contributing factor to growth growth. real estate investment-to-GDP, compared with Japan and Korea

Local government debt

- Local finance platform (LFP) debt is not equal to local government debt
- to supplement the famous 4 trillion Yuan stimulus package, local governments were encouraged to create SPVs (“local finance platforms”--LFPs) to borrow from banks with future government revenue as collateral to finance packaged-investment projects in the localities
- Total borrowing of LFPs amounts to 10.7 trillion Yuan, among which 79.1% was bank loans.
- LFP debts are largely performing
 - for the majority of the local finance platforms (LFPs), the cash flow generated by investment is enough to meet repayment of principal and interest. Majority of loans are repaid regularly
 - The non-performing ratio (NPL) is as low 2.28-2.33%.
- Banks’ coverage rates are very high
- China’s overall fiscal position is very strong
 - 10.7 trillion Yuan 27% of China’s GDP, central government debt and policy loans were 20% and 6% of GDP, respectively, China’s total public debt-to-GDP ratio was just above 53% of GDP, even better than Germany’s fiscal position

The breakdown of underground credit network

- Underground lending and borrowing has **a long history**.
- Whenever there is monetary tightening, staved by lack of credits, small and middle-sized private enterprises are prepared to borrow with suicidal high interest rates from relatives or loan sharks. In recent years, speculation in real estates has become another important source of demand for underground loans.
- When economic situation worsens and real asset prices fall, the local credit networks break down and leave hundreds families shattered. Thanks to credit rationing and interest rates control, many of loan sharks are able to borrow from commercial banks with cheap interest rates. As a result, banks suffer collateral damage.

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Continued

- total underground credit in Wenzhou accounts less than **20%** of total credit in the region, while the GDP of Wenzhou region accounts less than **1%** of China's GDP. The total amount of affected bank credits was just above 3 billion Yuan, accounts for some 0.5% of total loan extended by banks in Wenzhou region.
- The damage caused by the breakdown of Wenzhou underground credit network on regional banking system is very limit, let alone its national impacts.

Major long- term problems facing China

- Low investment efficiency
- Over dependent on external demand
- Serious market distortion in resource allocation
- Lack of ability of innovation and creation
- Pollution
- Wasteful use of resources
- Wide gap between different social group and between rural and urban areas
- Insufficient provision of social goods (social safety net, medic-care, education, etc.)
- Aging

Concluding remarks

- In recent months, bearish sentiment about the Chinese economy has surged, owing largely to three conjectures. In fact, despite its problems, so far China's economy remains in good condition. Indeed, it is not on the rock yet.
- Some balance is necessary. I wish to dispel the over bearish sentiment. But I do not wish to create an impression of complacency either.

continued

- Thus, despite the high likelihood that China's economic growth will slow significantly in 2012, a hard landing is unlikely. Nevertheless, while there is no need to be overly bearish about China's short-term economic prospects, because of the slow progress in fundamental adjustment and further reform, even Chinese Premier Wen Jiabao has noted that, China's growth is ultimately unsustainable. The real test has yet to come.)