

China Inside Out

Six macro themes in 2011

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Qu Hongbin

Chief Economist, Greater China
The Hongkong and Shanghai Banking Corporation Limited (HK)
+852 2822 2025 hongbinqu@hsbc.com.hk

Sun Junwei

Economist

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- ▶ **Rising inflation invites further policy tightening...**
- ▶ **...but the risk of Beijing choking off growth too much is remote**

Inflation has surprised to the upside since October. But is this just a temporary food price spike or something more serious? Beijing is responding mainly through quantitative tightening, subsidies and selling state grain reserves. What else do they still need to do? And how will these likely measures affect the economy? In this note we address these issues by identifying six key macro trends in 2011:

- ▶ **Inflation.** Despite recent moves to squeeze liquidity and lift food supply, inflation will stay high, at least in 1Q 2011. We have raised our whole-year 2011 CPI forecast to 3.9% y-o-y from 3.4%.
- ▶ **Quantitative tightening** will remain the primary tool used to check inflation. Expect over 200bp of reserve ratio hikes next year and credit growth to be capped below 16%. Modest rate hikes are needed to anchor inflation expectations. We now expect three 25bp rate hikes in the next 12 months (previously one hike).
- ▶ **Property cooling policy to stay in place.** A rebound in property prices would likely invite a property tax and other additional measures.
- ▶ **Growth will hold up.** Policy tightening will slow new investment projects. But continued investment in over 100,000 existing rail and highway projects, 10m units of public housing and still resilient consumer sentiment should support GDP growth of around 9% next year.
- ▶ **Renminbi trade settlement will expand exponentially.** Expect offshore renminbi products and renminbi outbound investment to take off next year.
- ▶ **Time to restructure local government debt.** We think the most likely option is to allow local governments to issue bonds to enable them to service their bank borrowings.

Six key macro themes in 2011

- ▶ Inflation to get worse before getting better, while growth will hold up
- ▶ Beijing will rely on aggressive quantitative tightening and modest rate hikes to check inflation
- ▶ It's time for local government bonds to take off, while the renminbi trade settlement is set to expand exponentially

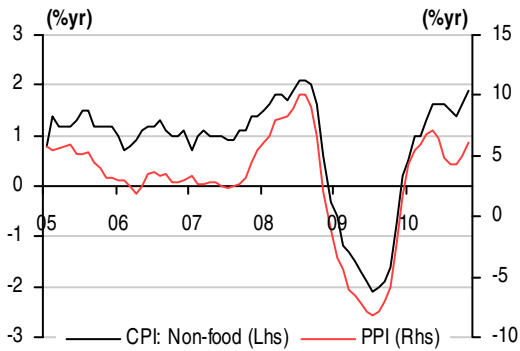
1) Inflation: It'll get worse before it gets better

Both inflation and growth numbers have surprised to the upside over the last few months, prompting China's policymakers to make battling inflation the top policy priority in 2011 (see *Inflation's the word*, 11 December; *Inflation the top concern*, 13 December). Despite the recent tightening (three reserve ratio hikes and a rate hike since October) and supply-side measures, we do not expect CPI inflation to slow meaningfully before 2Q 2011.

As a result, we are lifting our whole-year 2011 CPI forecast from 3.4% y-o-y to 3.9% y-o-y to reflect the following developments:

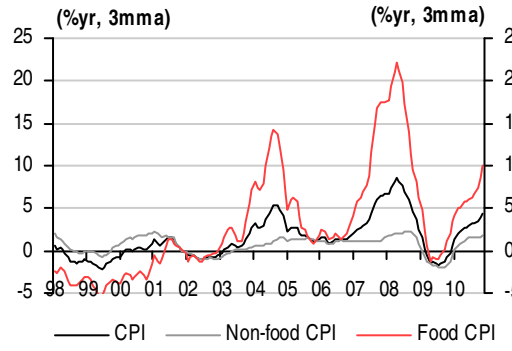
- ▶ Food prices and headline CPI have been rising faster than initially expected. In sequential terms, food prices and headline CPI accelerated to 2% m-o-m and 1.1% m-o-m last month, respectively. This points to high food prices into 1Q 2011. A seasonal factor, Lunar New Year, will also fuel food price spikes.
- ▶ Inflation expectations are rising faster. The People's Bank of China (PBoC) quarterly household survey suggests the index measuring household satisfaction with prices fell to 13.8 in 4Q, the lowest level since 4Q 1999. And over 61% of respondents expect further price increases in the next quarter, compared with 46.2% in 3Q.
- ▶ Higher international commodities prices amidst ample liquidity released by the Federal Reserve are likely to pass-through to higher PPI. And still strong domestic demand is likely to accelerate the translation from PPI to CPI. Non-food prices picked up to 1.9% y-o-y in November, from 1.5% in 3Q.

Chart 1. Faster translation from PPI to non-food CPI



Source: CEIC, HSBC

Chart 2. Food induced CPI inflation



Source: CEIC, HSBC

That said, in our view the risk of explosive inflation is remote. The inflation risk is broadly manageable and should be less severe than the period of 2007-1H 2008 when China was faced with both inflation and overheating. More specifically, we think headline CPI is likely to peak at over 5% y-o-y around Lunar New Year and start to moderate from 2Q.

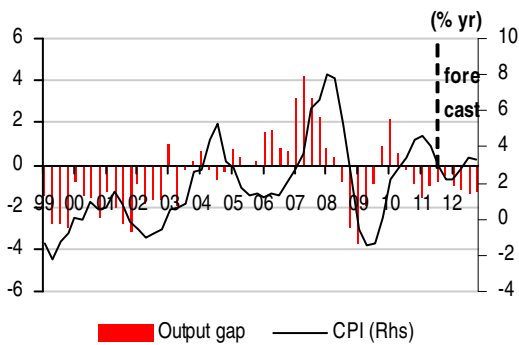
First of all, let's get the whole inflation picture right. It is food-price-induced inflation spikes that contributed over 70% of headline CPI. Core inflation remained contained at 1.5% as of November. The food supply and demand dynamics didn't show any imbalances in general, although vegetable and fruit prices surged unexpectedly due to cold weather and rising labour costs. The fundamentals of food supply are still strong, underpinned by seven consecutive years of good harvest and corresponding record-levels of state grain reserves (see [From the horse's mouth: How long will the latest spike in food prices last?](#), 26 November 2010).

Moreover, we believe Beijing has the experience and more than enough policy tools to combat food inflation. The State Council introduced supply-side measures, including providing subsidies to encourage food production, the sale of state reserves and even temporary price controls, if necessary. Although these measures won't slow prices overnight, their impact is likely to filter through in a few months. Signs are emerging that the prices of fresh vegetables, the key driver for the latest round of food price spikes, started softening sequentially towards end November.

Third, GDP growth has already cooled down from around 12% in 1Q 2010 to 9.6% in 3Q 2010. Recent policy tightening should slow the growth further to around 9% in the coming quarters. This is in contrast to the picture in 2007 when the economy was growing at an overheated pace of over 13%. A sub-trend growth rate in the coming quarters should help to prevent broad-based inflation from getting out of control, even though there is still excessive liquidity in the system.

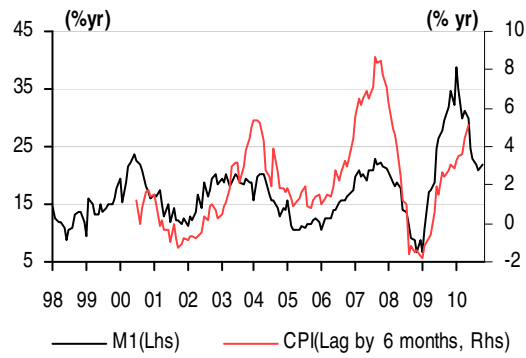
Last, but not least, money supply growth has slowed significantly from over 30% at the start of the year to 19.5% by end November. Given that Beijing has also been stepping up efforts to squeeze liquidity, credit growth is likely to continue to cool down in the coming quarters. Slower monetary growth should also help curb core inflation in 2011

Chart 3. Output gap and inflation



Source: CEIC, HSBC

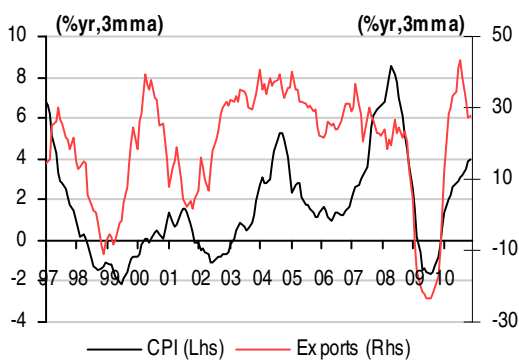
Chart 4. Slowing monetary growth to curb inflation



Source: CEIC, HSBC

It is also worth monitoring export growth when gauging inflation pressure in China. Surging export growth tends to fuel growth and stretch production in the manufacturing sector, ultimately resulting in additional inflation pressure. But we are more likely to see slower export growth in 2011 than this year's likely +30% y-o-y and an average of over 25% in the pre-financial crisis period. In other words, manufacturing sector inflation should be relatively contained compared with the previous inflation cycle.

Chart 5. Exports vs. CPI



Source: CEIC, HSBC

2) Growth to hold up at c9%

It is all about domestic demand

Exports are set to slow in tandem with weaker growth in the developed world and softer growth in emerging markets. However, there is enough growth momentum on the domestic front to hold up GDP growth at around 9% in 2011, well above the 8% official growth target.

This time around, the recovery has been mainly driven by China's domestic demand, not exports. Exports were a big drag (-3.7ppt) on China's 8.7% growth in 2009, becoming a moderately positive 0.7ppt in the 10.3% GDP growth in the first three quarters. Looking into next year, the contribution from net exports is likely to be marginal, given that world economic growth is likely to slow and China's domestic demand is expected to hold up improved import growth.

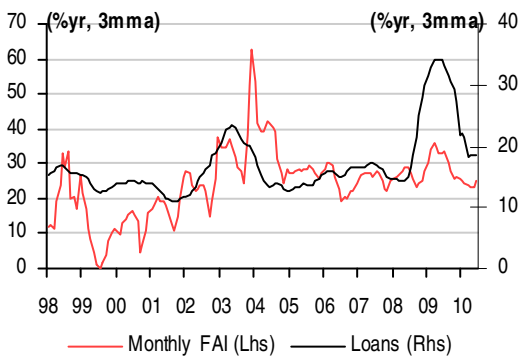
Moreover, China's growth is likely to be more balanced in 2011, with less reliance on investment and more contribution from consumption.

Over 100,000 existing infrastructure projects

Will China's domestic demand slip as the stimulus effect wears off in 2011? We think not. While the stimulus package (end 2008 to 2010) should have a much smaller impact next year, in particular on a y-o-y comparison, China's domestic demand is showing great resilience in the post stimulus era. We expect growth in fixed-asset investment to hold up at around 21.5% y-o-y (in nominal terms) next year (vs. 24% in 2010) for the following reasons:

- ▶ Continued investment in over 100,000 existing infrastructure projects will provide a floor to the investment slowdown. Credit tightening has been slowing the pace of new infrastructure projects. But Beijing has already made it clear that this won't affect the funding for existing railway, highway and airport projects. In fact, next year's 16% target for monetary growth means that there will be more than enough funds to support the construction of these big projects.
- ▶ Beijing's plan to boost the supply of public rental housing from 5.8m units this year to 10m next year should offset part of the anticipated slowdown in private sector property investment. This requires RMB1.4-1.5trn investment, likely contributing 6-7ppt to property investment growth next year.
- ▶ The Western Development Strategy and the plan for accelerating the development of strategic new industries should also provide powerful support to investment growth next year.

Chart 6. Investment to hold up well

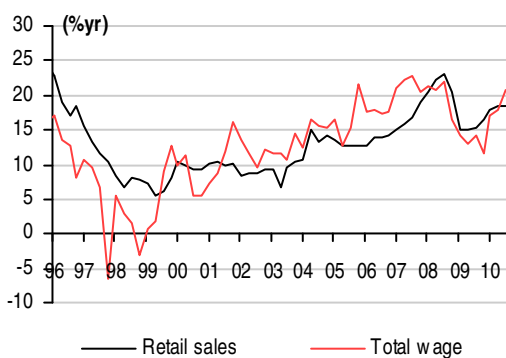


Source: CEIC, HSBC

China consumers have deep pockets

More importantly, China's consumers have deep pockets. This time round the recovery has filtered through into the labour market, as evidenced by significant wage growth and the continuous increase in employment components of HSBC China PMIs. Since wage income accounts for 80% of household income, this should enable more consumer spending. And the propensity to consume is likely to be lifted given the improvement in social security and public housing. Consumer spending is unlikely to be affected if property tightening continues in the coming quarters, not least because of the still low leverage of Chinese households.

Chart 7. Wage growth driving consumer spending

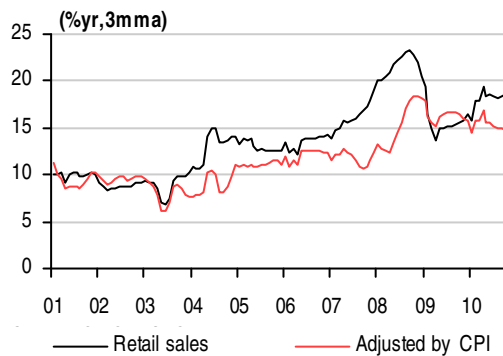


Source: CEIC, HSBC

Will the rise in CPI undermine consumer consumption? Not really. The hike in food prices

can serve as an income transfer tool to boost farmers' incomes – and the farmers have a higher propensity to consume. While this might not be good news for urban citizens, especially the low-income group, the government has stepped up efforts to subsidise the most vulnerable groups, such as poor families and retired workers. This should effectively offset the negative impact of rising food prices. On balance, consumer consumption should perform well despite higher inflation. We note that, historically, consumer spending remained stable during the last round of high inflation.

Chart 8. Consumer spending to stay resilient

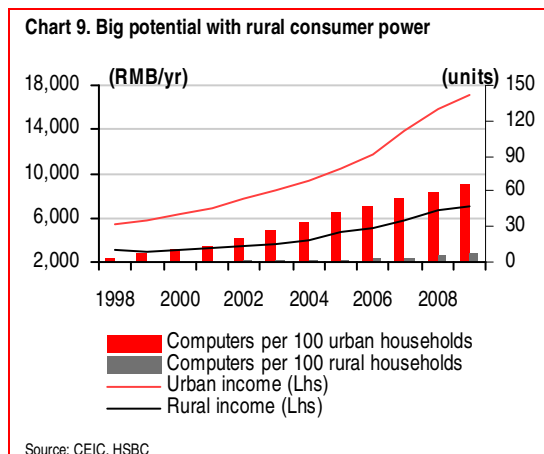


Source: CEIC, HSBC

In addition, we identify two major structural factors that should boost consumer spending in the coming year:

Income distribution reform: This is likely to be accelerated in the next year as one of the key policy initiatives of the 12th Five-year Plan to lift domestic consumer consumption via faster growth of household income. These are likely to be increasing subsidies to farmers and the urban low-income groups. Meanwhile, personal income tax reform (lifting the threshold and adjusting the tax ratio) is also expected to reduce the households' tax burden. This should be an additional boost to household income and consumer spending.

Rural consumption power: This should be a crucial factor in the next few years. Farmers' incomes have been growing strongly at 9.7% y-o-y for the first three quarters, higher than 7.5% for urban peers. The increase in minimum purchasing prices and the enhanced subsidies to encourage the production of agricultural products should continue to support strong income growth for rural households. This, in turn, should help close the income gap with urban households, implying more demand for home appliances, cars and services.



Will policy tightening choke off growth?

While the recent strong growth numbers provide more room to tackle inflation in a more hawkish manner, Beijing's quantitative tightening is unlikely to choke off growth.

The tightening is unlikely to be too aggressive, aiming at lowering monetary growth from the current rate of around 19%y-o-y (November) to 16% by the end of next year. This is quite mild compared with monetary policy seen over the course of this year: M2 growth falling from 30% at the beginning of 2010 to 19.5% in November and bank lending from nearly RMB10trn last year to around RMB8trn this year.

Beijing has learnt the lesson of 2008 and avoided aggressive tightening that can cause big swings in

growth. Moreover, while the loan quota is lower for next year, priority will be given to financing ongoing infrastructure projects to avoid ending otherwise viable projects before completion. This should minimise the risk of bad loans and damage to the bank-dominated financial system.

To sum up, we expect growth to be around 9% in 2011 with a more balanced structure. This moderation is healthy, particularly now that consumer demand is making a larger contribution to GDP growth. The risk is likely to the upside, as local governments seem to be aggressively starting new projects at the start of the 12th Five-year Plan.

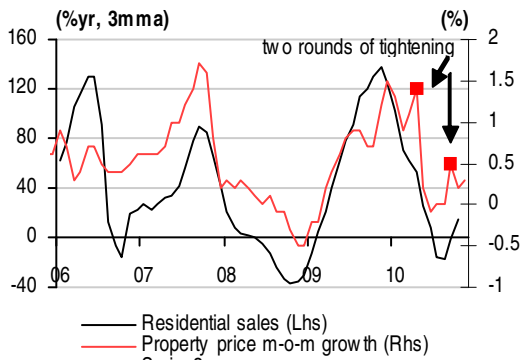
3) Property cooling measures to stay

With few worries about growth, Beijing policymakers can focus on containing asset price inflation. We expect the property cooling policy to stay in place through 2011. Any relaxation could see a rebound in property prices, damaging the credibility of policymakers.

Continuous property tightening is crucial to avoiding a property bubble in the QE2 era. Putting aside the government's credibility, keeping property prices under control will not only help anchor inflation expectations, but also help discourage speculative capital inflows.

So far, the measures seem to be working. Growth in housing sales has been dropping sharply since April. A small rebound in property sales and prices in September triggered a second round of cooling measures, demonstrating policymakers' determination to curb property prices.

Chart 10. Beijing determined to cool property market



Source: CEIC, HSBC

Additional property cooling measures are likely in 2011, especially if property prices in big cities rebound. Measures could include: 1) more stringent mortgage standards; 2) tightening credit to property developers; 3) accelerating property tax reform; 4) strict restrictions (or ban) on third home purchases.

A pilot property tax could be trialled in Shanghai and Chongqing, with the option to expand the programme to other big cities. A property tax would likely be a drag on property prices, according to research by the Development and Research Centre, a think tank under the State Council.

That said, we don't expect tightening to cause a collapse in property prices, given the urbanisation-driven demand for housing, low real interest rates and the absence of alternative vehicles for long-term investment.

4) Quantitative tightening to counter QE2

China will shift from "appropriately loose" to "prudent" monetary policy to check liquidity in 2011. This was announced by the Central Economic Work Conference on 12 December. The last time China adopted a prudent monetary policy was 1998-2006, before switching to an "appropriately tight" policy in 2007. This time around, the change of wording highlighted the

ongoing normalisation of monetary policy and indicated a green light for a *de facto* moderate tightening bias to check inflationary pressure and counter QE2 in the coming quarters.

Quantitative tightening will be the primary and most effective tool to mop up liquidity and check inflation pressure against sub-potential growth outlook, in our view. With banking still dominating financial intermediation, bank loans remain the largest contributor to money supply and liquidity.

The reality is that bank lending is excessive and liquidity is more than abundant. As well as the unfavourable side effects of the stimulus package that released nearly RMB10trn last year, this year's RMB7.5trn bank lending quota is likely to be breached (RMB7.46trn as of end November). Despite six reserve ratio hikes and strong monitoring of bank lending, broad money supply still rose 19% y-o-y, higher than the 17% annual target and the average of 16% for the decade before the financial crisis.

Even worse, the US Fed's QE2 seems to have pumped more speculative money into China, complicating the task of managing liquidity. Therefore, setting a lower credit and money supply growth target should restrain the reflationary pressure, which is also critical to managing inflation expectations.

We expect the PBoC to continue to normalise credit growth in 2011, aiming at bringing down monetary growth (M2 broad money supply) from the current rate of around 19% to around 16%. The main policy tightening measures in 2011 include:

- ▶ Credit growth to be capped below 16% for next year from currently over 19%. The regulators will likely use window guidance and other administrative tools to prevent banks from lending excessively. They are also

plugging the regulatory holes to stop banks from shifting to trust loans and other off balance sheet lending.

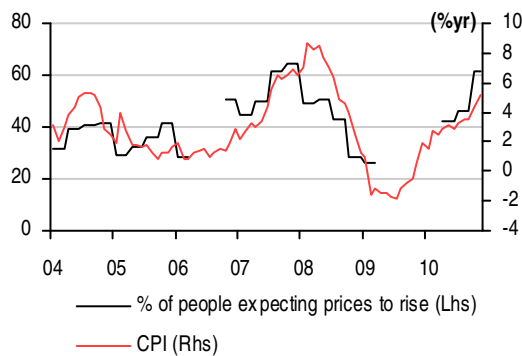
- ▶ At least another 200bp of reserve ratio hikes in the coming quarters. Reserve ratio hikes and central bank bills issuance are the PBoC's main policy tools to mop up excess liquidity from the banking system. Although slowing the monetary growth from 19% to 16% by the end of next year seems easy enough, capital inflows caused by the Fed's QE2 require the PBoC to do more to absorb liquidity. We expect each 50bp reserve ratio hike to freeze RMB350bn (or USD53bn) liquidity in the banking system.
- ▶ Moderate rate hikes to anchor inflation expectations. We revise our interest rate call for 2011 from no change to two 25bp lending and deposit rate hikes. In other words, we now expect three rate hikes in total over the next 12 months.
- ▶ Last, but not least, improving macro-prudential supervision. More specifically, dynamic provisions and additional prudential capital measures should mitigate the cyclical lending pattern and smooth the credit growth at an appropriate pace.

Moderate interest rates hikes are needed to anchor inflationary expectations. We now expect another rate hike before the end of 2010 and another two hikes (25bp each) in 2011. At 2.5% for one-year deposits after the October rate hike, China's nominal deposit rate is still low by historical standards. Actually, the real deposit rate has fallen deeper into negative territory with headline CPI shooting up to a 28-month high in November. This will reinforce inflation expectations as there is a tight correlation between household inflation expectations and the CPI (Chart 11).

The PBoC survey suggests that household expectations on prices have surged to the highest level in a decade, underlining the urgency of managing inflationary expectations. The latest reduction in bank deposits also reflected the inflows into equity or asset market amidst heightened inflation expectations. With inflation likely to stay above 4% for the coming six months, deposit interest rates need to rise in order to ease pressure on negative interest rates and anchor inflationary expectations.

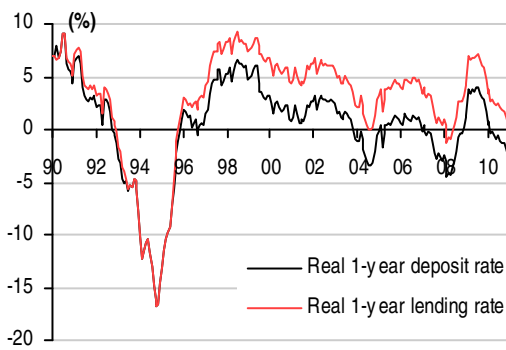
That said, the PBoC can't hike rates too aggressively because that may attract more capital inflows, especially given the zero interest rate policy in the US and Hong Kong. Another concern is local government financing vehicles' massive debt (RMB7.6trn at the end of June 2010), so aggressive rate hikes may make the problem worse.

Chart 11. Inflation expectations are picking up, along with rising negative real interest rates



Source: CEIC, HSBC

Chart 12. Real deposit rates have been negative for 10 months



Source: CEIC, HSBC

We expect the RMB to continue to gradually appreciate against the USD in 2011. But Beijing is unlikely to use appreciation as a main policy tool to combat inflation. As we have long argued (see *China Economic Insight: Three big misconceptions*, 6 May 2010), since China, as the world's largest consumer of commodities and resources, is already a price setter in the global commodities and resources market, RMB appreciation will be much less effective than many expect in containing imported inflation.

Any change in China's demand is likely to affect global prices for commodities and energy. So an appreciation will lower the RMB prices of imported commodities in China but will also lead to a rise in Chinese demand for commodities, which, in turn, will push up the global prices for commodities.

5) Time to restructure local government debt

We think it's high time for China to act decisively to restructure local government debt, which topped RMB7.7trn as of end June 2010, according to China Banking Regulatory Commission (CBRC). Most of these local government loans are in essence delayed fiscal spending, as the bulk of them have been channelled into infrastructure projects sitting at the heart of last year's RMB4trn stimulus package.

Local government debt should be strictly controlled next year, according to the Central Economic Work Conference. This is necessary to prevent another round of debt accumulation, but Beijing still needs to come up with a solution to finance the huge needs of local infrastructure construction.

In our view, the most feasible option is a bonds-for-loans swap scheme, specially designed to get China's banks off the hook. The central government would issue more long-term construction bonds on behalf of local governments, enabling them to repay the loans initially used to fund pure public work projects. As this option doesn't require any change to the current central-local fiscal framework, we think it will likely be the easiest to execute.

Since last year, Beijing has issued RMB200bn of bonds on behalf of some provincial governments in support of selected local projects. Moreover, compared to the direct issuance of debt by local governments, central government debt issuance should incur a lower cost of funding. Demand for such central government bonds should not be an issue, given: 1) the huge pool of funds currently sitting idle in individual deposit saving accounts (RMB27trn); and 2) the demand for such government debt instruments that's being cultivated by growing contractual savings such as insurance and mutual funds in China.

We also expect Beijing to introduce a pilot programme allowing local governments to issue debt in their own names. The Ministry of Finance's debt issuance on behalf of local governments is more likely to be a transitional arrangement during the crisis period. But the need to restructure local government debt requires both more transparency in local government balance sheets and sustained funding to local infrastructure projects. Therefore, to allow local governments to issue debt in their own names to

finance specific projects should be a sound option that could be exercised in the future.

6) RMB trade settlement to expand exponentially

Renminbi trade settlement has been taking off amidst huge potential demand; overwhelming response from banks and Beijing's policy commitment (see *The rise of the redback*, published 8 November 2010).

Table 1. Key policies promoting RMB internationalisation

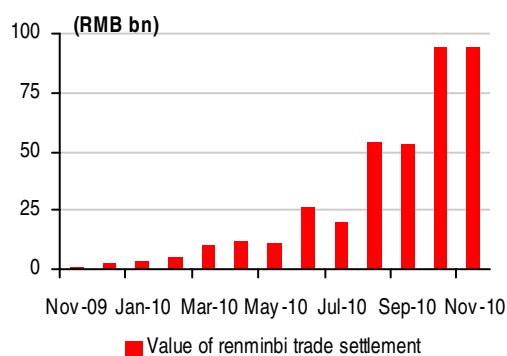
Date	Measures
29 Jun-09	PBoC and HKMA Memorandum on RMB trade settlement in Hong Kong
3 Jul-09	Pilot Scheme for Settlement of Cross-Border Trade in RMB released by the PBoC
19 Jun-10	Reform of RMB exchange rate regime resumed
22 Jun-10	Expansion of the RMB Trade Settlement Scheme
16 Aug-10	RMB Clearing Bank, foreign central banks and other eligible institutions outside the Mainland are allowed to invest their RMB funds into the Mainland's interbank bond market
27-Aug-10	Selected enterprises in Beijing, Guangdong, Shandong and Jiangsu are allowed to keep export proceeds offshore

Source: HSBC

Progress so far has been great:

- ▶ Exporting companies participating in RMB trade settlement have expanded from 365 to over 67,359.
- ▶ Transaction volume saw explosive growth from a monthly average of RMB0.6bn in 2009 to RMB68bn in June-November 2010.
- ▶ Regions involved in the RMB trade settlement programme cover more than 90% of China's trade.

Chart13. RMB trade settlement taking off



Source: PBoC, HSBC estimates

We expect the pace of RMB internationalisation to accelerate in the coming years, as RMB trade settlement will continue to grow rapidly. Besides the strong policy push, enterprises have responded enthusiastically not least because of the reduction in exchange rate conversion cost. Moreover, the infrastructure and clearing network for RMB trade settlement has been operating smoothly during the 1.5-year pilot programme.

Secondly, the RMB should make strides in the transition from trade settlement to investment. The fast growth of RMB trade settlement is making the currency more widely used in trade channels. The larger amounts used in trade, the more likely it is that RMB will be used in investment.

- ▶ Following the opening-up of China's interbank market to foreign central banks and clearance banks, the RMB has completed the circle from offshore to onshore and from trade settlement to investment. The mini-QFII scheme is likely to be trialled faster than many expect, according to newswire reports.

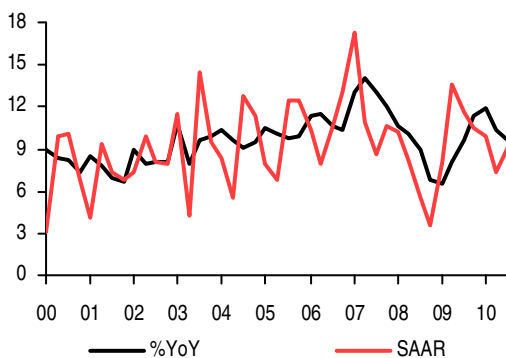
- ▶ The rapid expansion of the offshore RMB market encourages trade partners to use the currency. Apart from the authorities' initiative to position Hong Kong as an offshore RMB centre, the RMB-denominated financial tools are all available in Hong Kong. RMB is now a deliverable, convertible and transferable currency in the Hong Kong market, and there are few restrictions on foreign investors. This should allow the RMB accumulated from trade settlement to be invested in Hong Kong.
- ▶ Rising overseas RMB demand will make it possible for outward direct investment in RMB. China's outward direct investment accelerated from USD12.3bn in 2005 to USD56.5bn in 2009, the fifth largest source of direct investment. By geography, over 63% of investment went to Hong Kong while investment in emerging markets also grew quickly. There is surging demand for RMB in these markets. In the Hong Kong bond market, y-t-d RMB bond issuance accounts for just 17% of the net increase in RMB deposits there. Direct investment in Africa and Latin America rose sharply last year, by 55% and 100%, respectively, although is still a relatively small share of the total. The trade cycle between China and the emerging world implies huge potential for RMB demand and the wider use of RMB in direct investment.

Charts

GDP

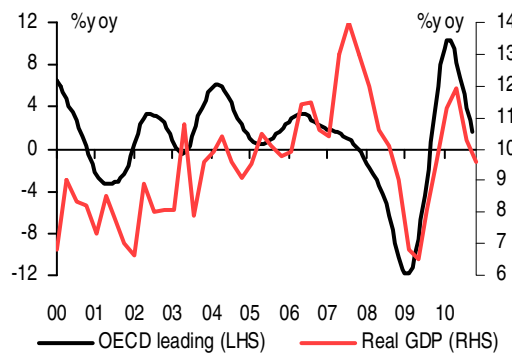
- ▶ Beijing has been trying to strike a balance between inflation and growth for a while. But times have changed, with both inflation and growth figures surprising to the upside
- ▶ Both domestic and external demand posted strong numbers in November, implying strong growth momentum
- ▶ Despite softer export growth and ongoing property tightening, the massive ongoing investment and resilient private consumption imply around 9% growth in 2011

1. Long-term real GDP trend



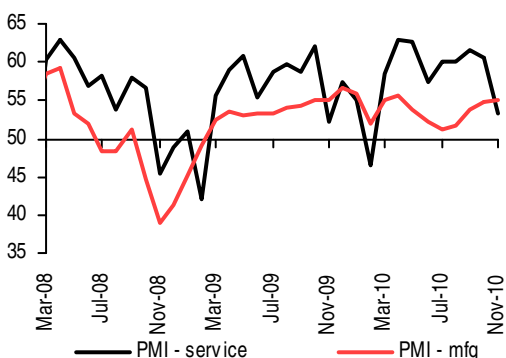
Source: CEIC, HSBC

2. OECD leading index vs China real GDP



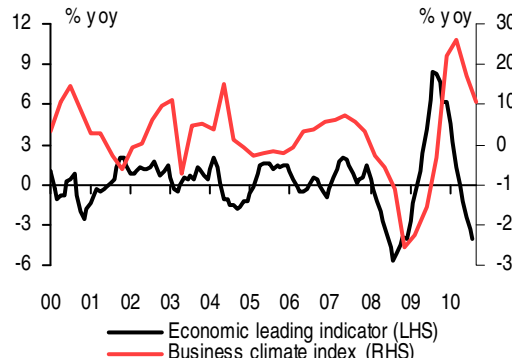
Source: CEIC, HSBC

3. Service and manufacturing PMI



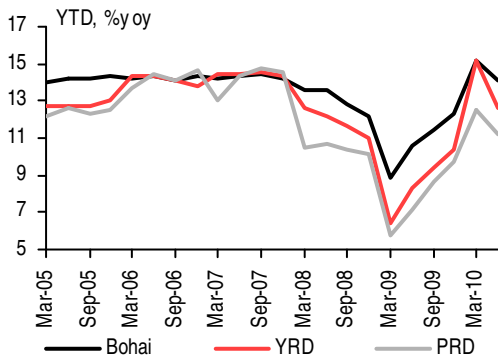
Source: CEIC, HSBC

4. Economic leading indicator vs business climate change



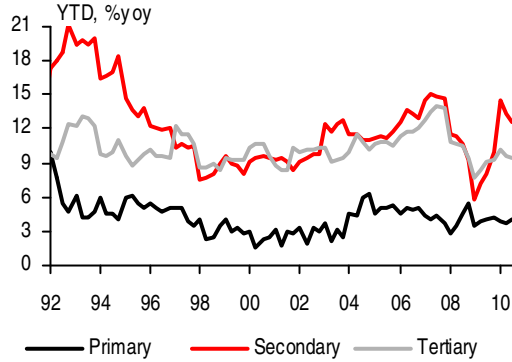
Source: CEIC, HSBC

5. GDP by region (nominal GDP, weighted)



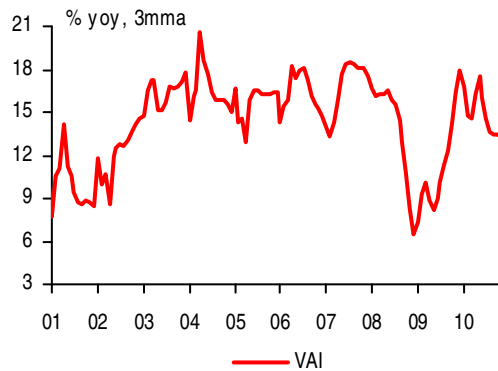
Source: CEIC, HSBC

6. GDP by industry



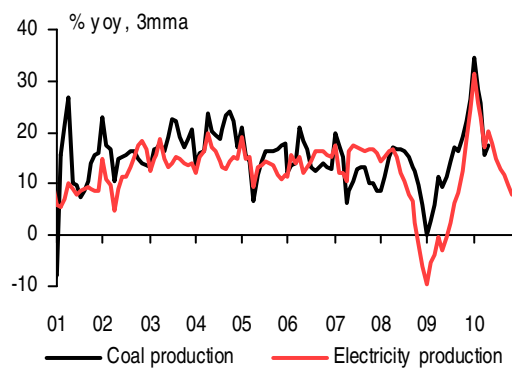
Source: CEIC, HSBC

7. Industrial production



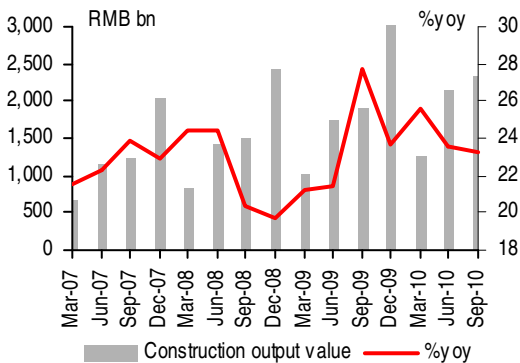
Source: CEIC, HSBC

8. Commodity production



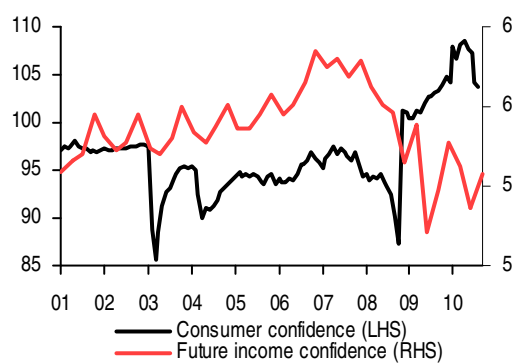
Source: CEIC, HSBC

9. Construction sector



Source: CEIC, HSBC

10. Confidence indices

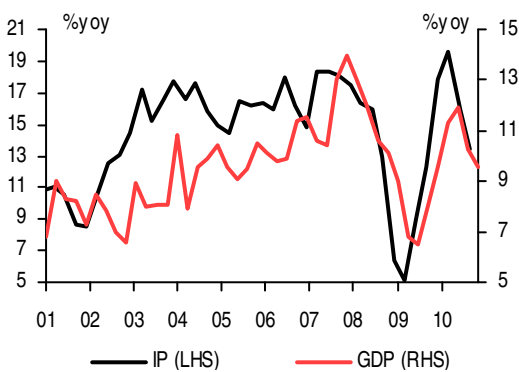


Source: CEIC, HSBC

Industrial production

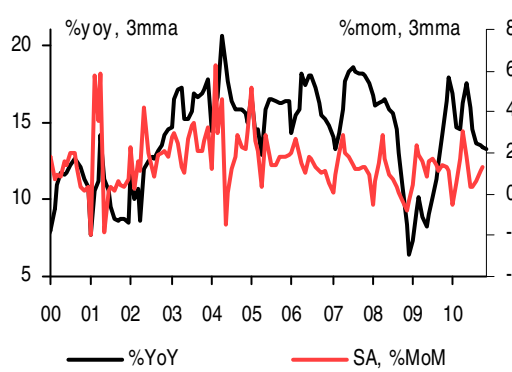
- ▶ Industrial production growth rose to 13.3% y-o-y in November, higher than consensus forecast of 13% and 13.1% in October
- ▶ The growth of heavy industries rose to 13.6% y-o-y from 13.2% in October, while light industries moderated to 12.7% y-o-y from 12.9% in October
- ▶ This improvement is consistent with the upbeat manufacturing PMIs and IP growth should be resilient despite the ongoing energy-efficient measures towards year-end

1. Industrial production vs GDP



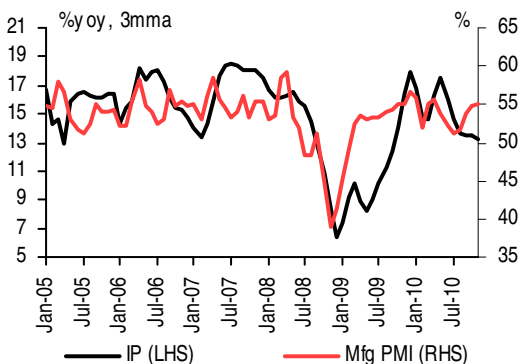
Source: CEIC, HSBC

2. Industrial production growth trend



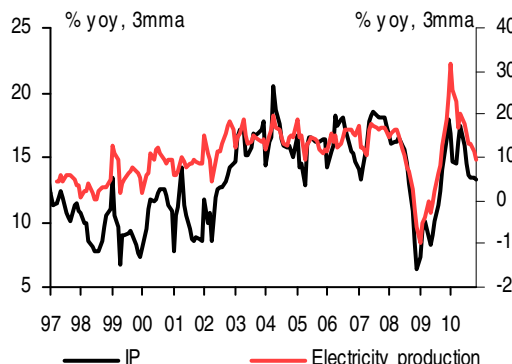
Source: CEIC, HSBC

3. Industrial production vs manufacturing PMI



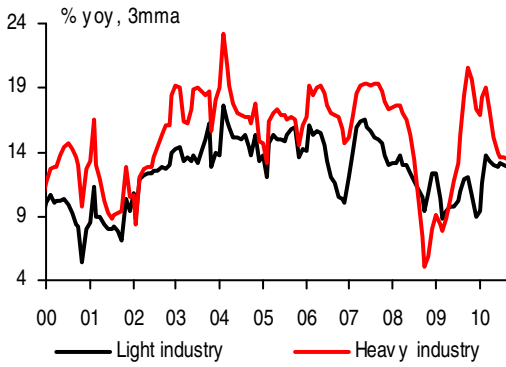
Source: CEIC, HSBC

4. Electricity production changes together with IP



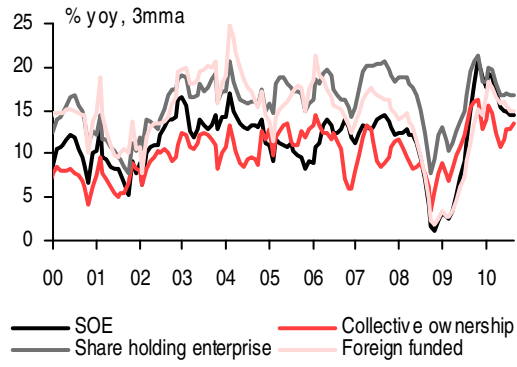
Source: CEIC, HSBC

5. Production by light and heavy industries



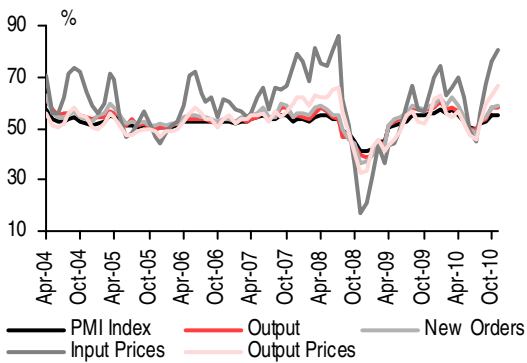
Source: CEIC, HSBC

6. Production by enterprise ownership



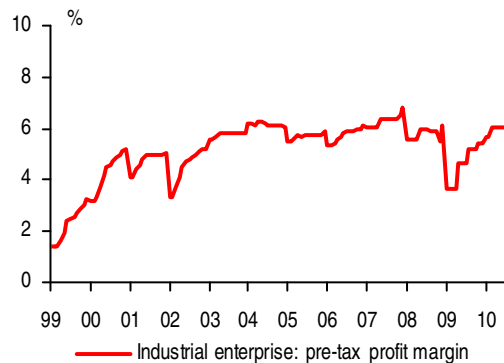
Source: CEIC, HSBC

7. Manufacturing PMI breakdown



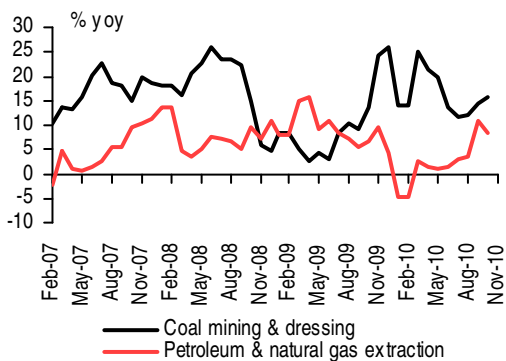
Source: CEIC, HSBC

8. Industrial profit margin



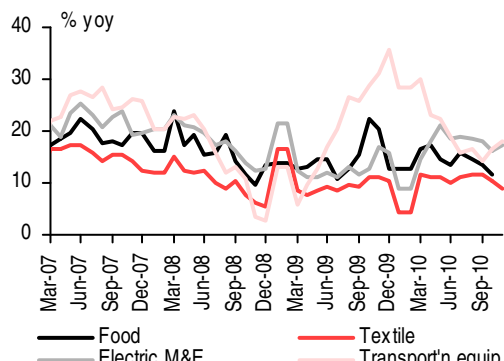
Source: CEIC, HSBC

9. Mining, petroleum and natural gas extraction



Source: CEIC, HSBC

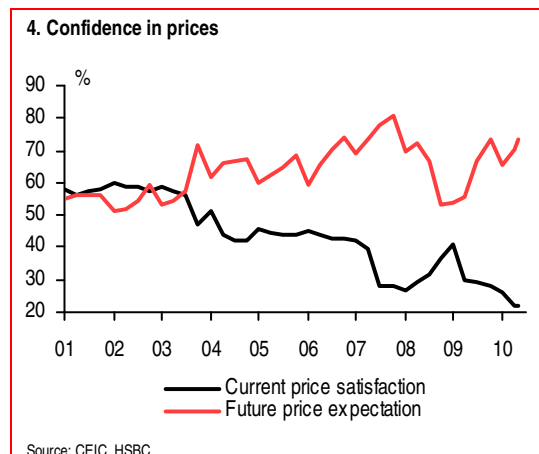
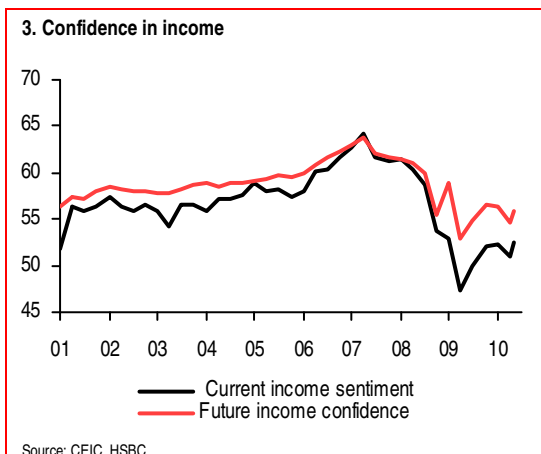
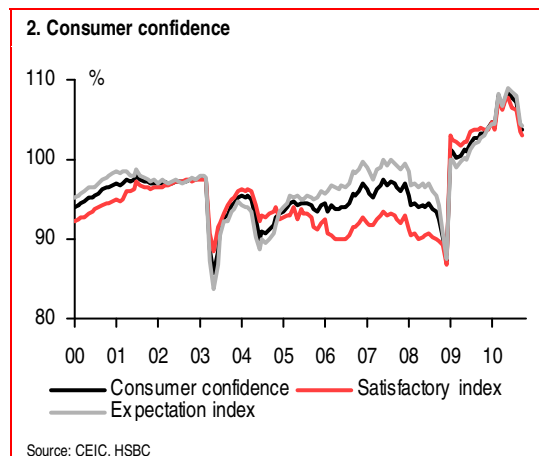
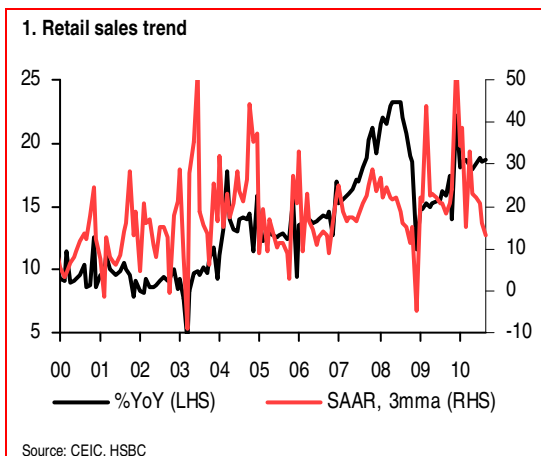
10. Manufacturing production



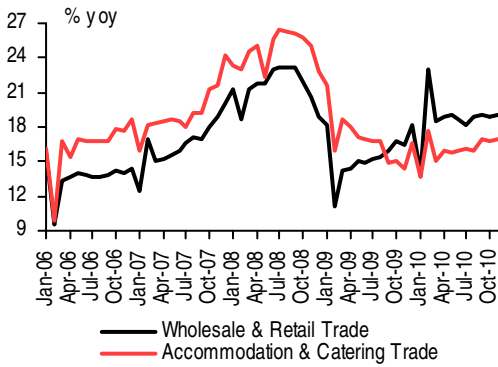
Source: CEIC, HSBC

Private consumption

- ▶ Retail sales growth remained stable at 18.7% y-o-y, marginally higher than 18.6% in October, but real growth of retail sales continued to slow to 13.6% from 14.2% in October
- ▶ Rapid food inflation may have eroded purchasing power of low-income groups. But in general durable goods consumption has been holding up reasonably well
- ▶ Private consumption should be broadly stable, thanks to steady income growth and pro-consumption measures

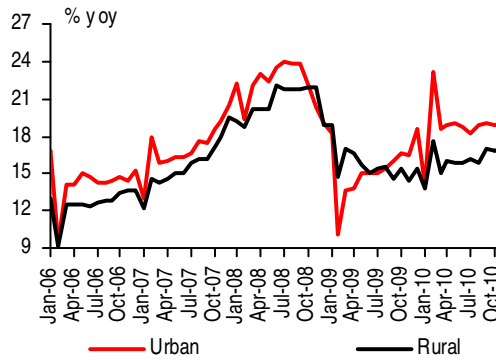


5. Retail sales by sector



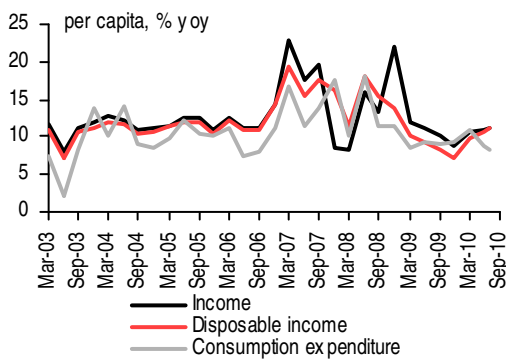
Source: CEIC, HSBC

6. Retail sales in urban vs rural areas



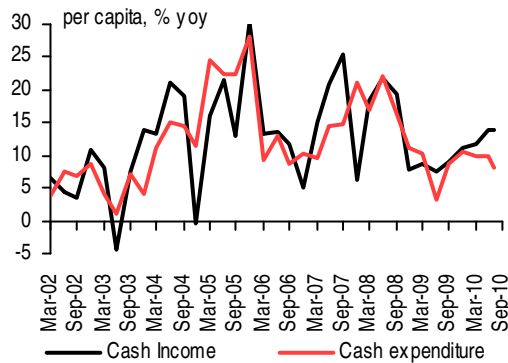
Source: CEIC, HSBC

7. Per-capita income vs expenditure – Urban households



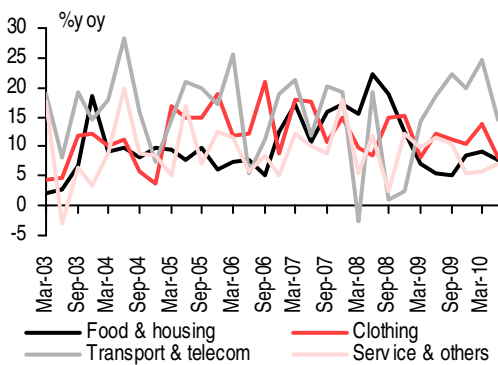
Source: CEIC, HSBC

8. Per-capita income vs expenditure – Rural households



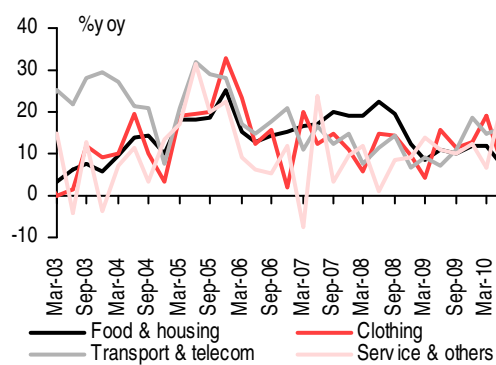
Source: CEIC, HSBC

9. Expenditure by product – Urban households



Source: CEIC, HSBC

10. Expenditure by product – Rural households

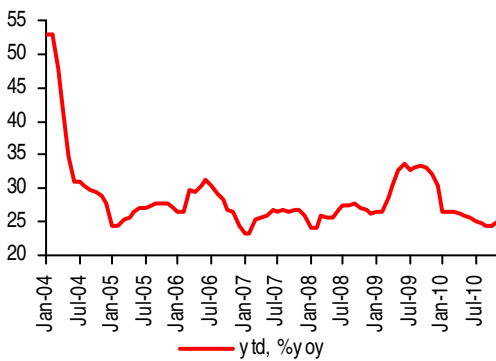


Source: CEIC, HSBC

Fixed investment

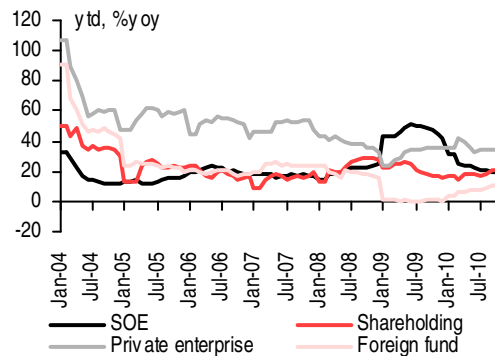
- ▶ Ytd fixed asset investment growth rose to 24.9% y-o-y, reversing the slowdown seen over the course of this year, implying 29% y-o-y growth in November (vs. 23% y-o-y in October)
- ▶ Putting aside the strong credit growth, this is likely due to faster fiscal spending to meet scheduled budget expenditure and the balance of the stimulus package towards year-end
- ▶ Property investment growth remained strong at 36.5% y-o-y for the first 11 months of 2010, likely boosted by acceleration in public housing construction

1. FAI growth



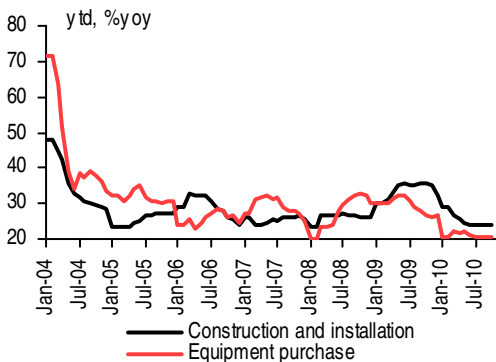
Source: CEIC, HSBC

2. FAI by enterprise ownership



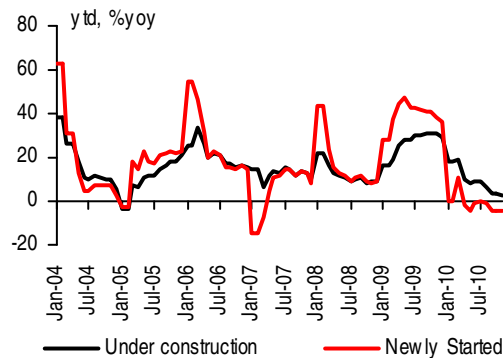
Source: CEIC, HSBC

3. Construction vs equipment purchase



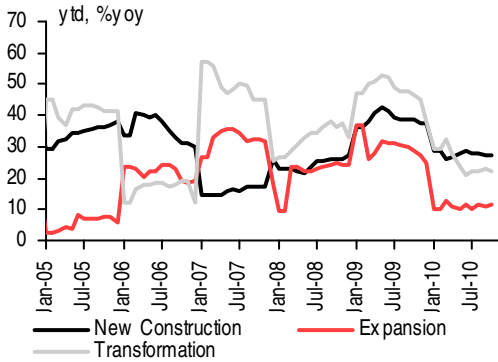
Source: CEIC, HSBC

4. Number of projects started and under construction



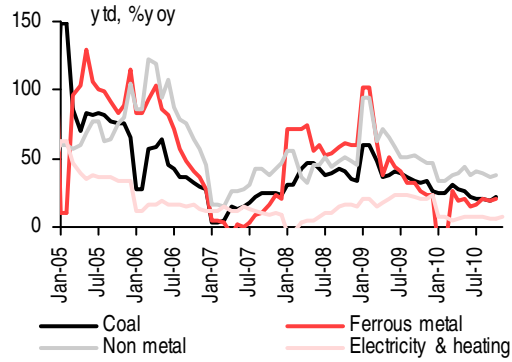
Source: CEIC, HSBC

5. FAI by work type



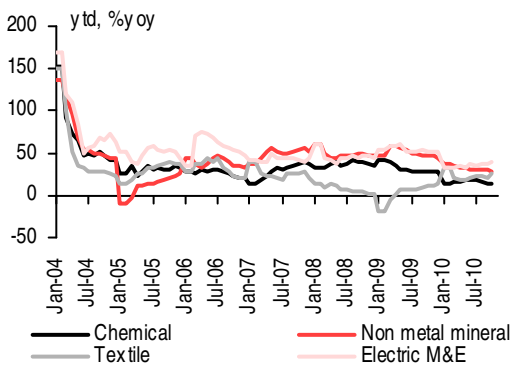
Source: CEIC, HSBC

6. FAI in mining sector



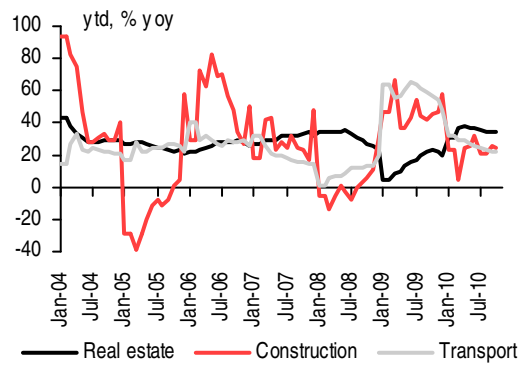
Source: CEIC, HSBC

7. FAI in manufacturing sectors



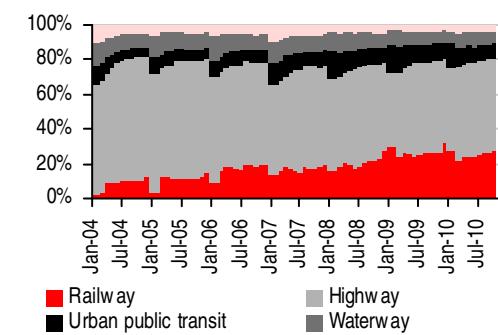
Source: CEIC, HSBC

8. FAI in construction, real estate and transport



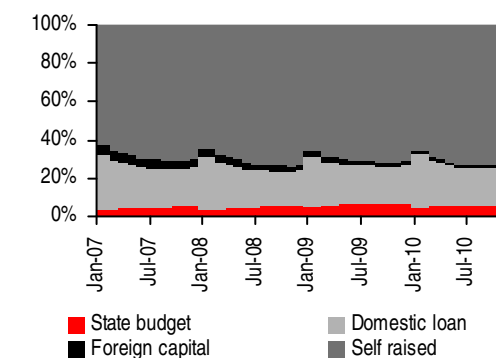
Source: CEIC, HSBC

9. FAI by infrastructure project



Source: CEIC, HSBC

10. FAI by source of financing

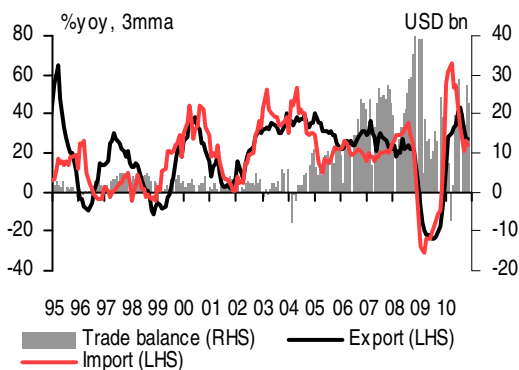


Source: CEIC, HSBC

Trade

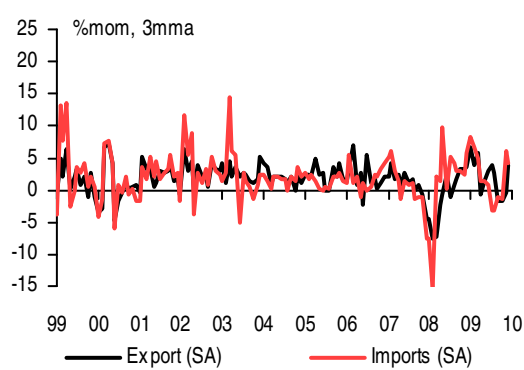
- ▶ China's November exports surprisingly surged 34.9% y-o-y, or 5% m-o-m seasonally adjusted, largely boosted by better shipments to the developed world
- ▶ Imports growth soared 37.7% y-o-y in November from 25.3% y-o-y in October, underlining the strength of China's domestic demand
- ▶ November trade surplus came in higher than consensus but in line with our forecast at USD22.9bn, still sizeable though smaller than the USD27.1bn in October

1. Overall external trade trend



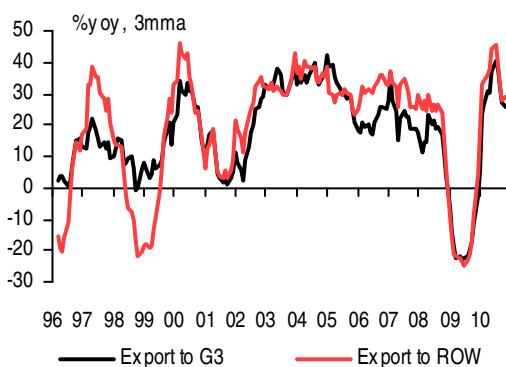
Source: CEIC, HSBC

2. Sequential growth in exports and imports



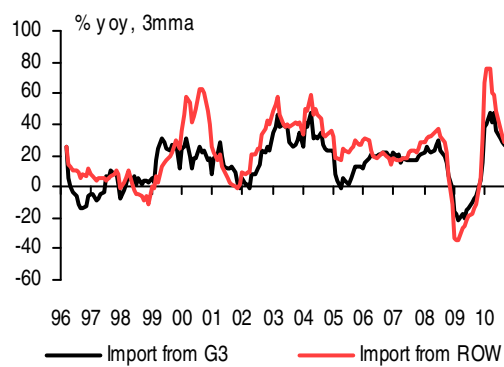
Source: CEIC, HSBC

3. Exports to G3 and ROW



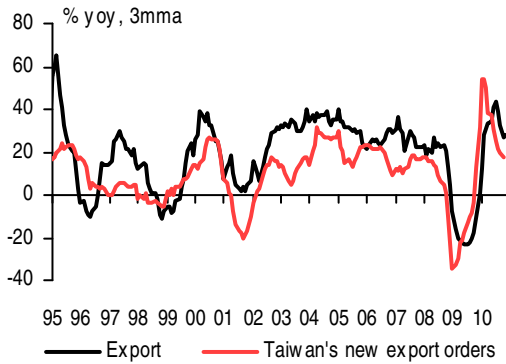
Source: CEIC, HSBC

4. Imports from G3 and ROW



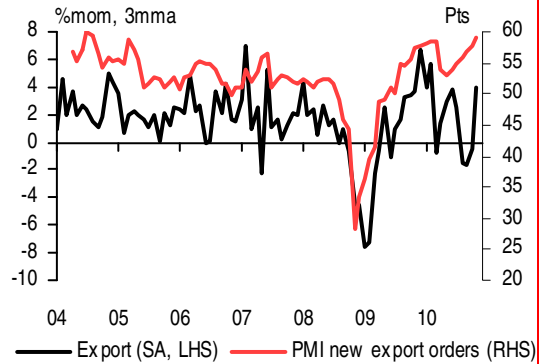
Source: CEIC, HSBC

5. Taiwan's new export orders as a leading indicator



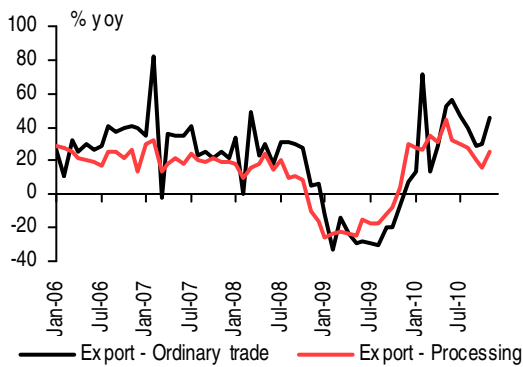
Source: CEIC, HSBC

6. PMI new export orders vs exports



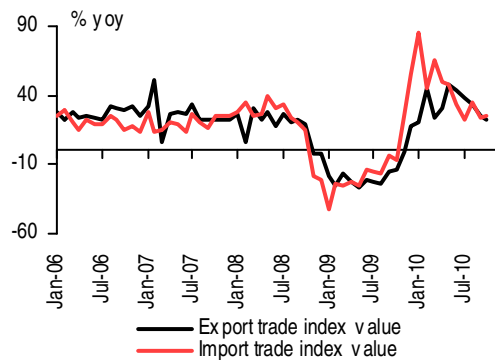
Source: CEIC, HSBC

7. Exports – ordinary vs processing trade



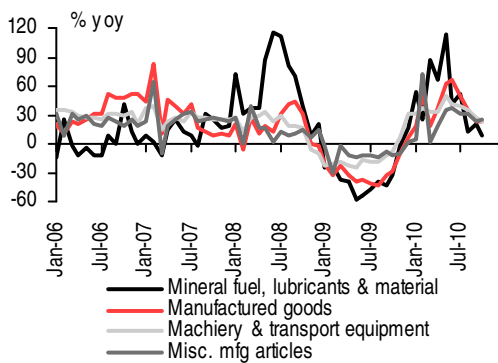
Source: CEIC, HSBC

8. Trade price index



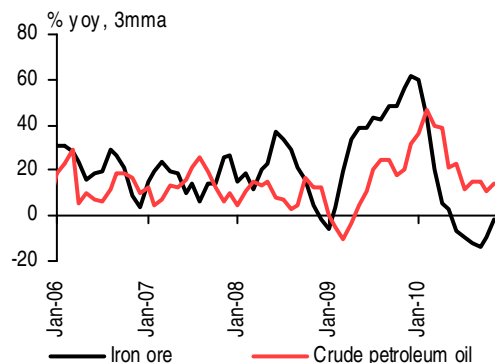
Source: CEIC, HSBC

9. Exports by major commodities



Source: CEIC, HSBC

10. Imports by major commodities

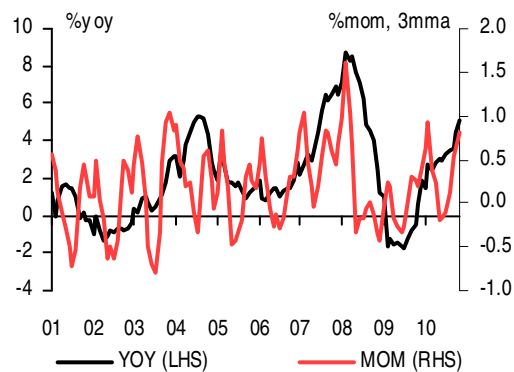


Source: CEIC, HSBC

Prices

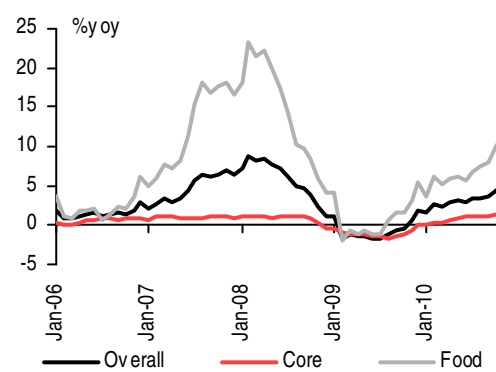
- ▶ Market was caught out again by another upside surprise in producer and consumer prices; inflationary pressure is on the rise
- ▶ November CPI hit a 28-month high at 5.1% y-o-y, mainly driven by the 11.7% y-o-y increase in food prices and the pick-up in non-food prices
- ▶ We expect CPI to stay high in 1H 2011 with the peak likely over 5% in 1Q 2011

1. Consumer price trend



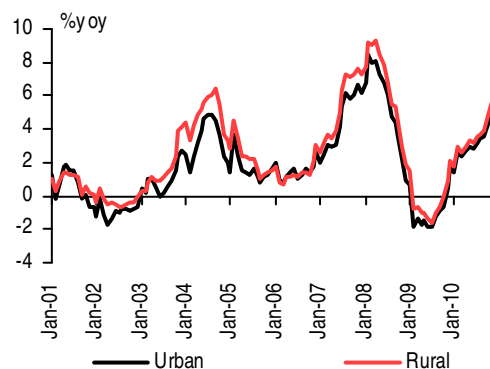
Source: CEIC, HSBC

2. CPI by major segment



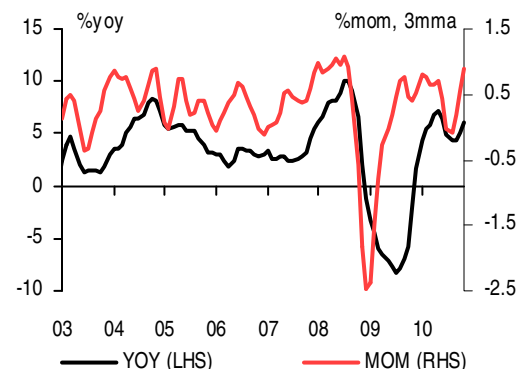
Source: CEIC, HSBC

3. Urban vs rural inflation



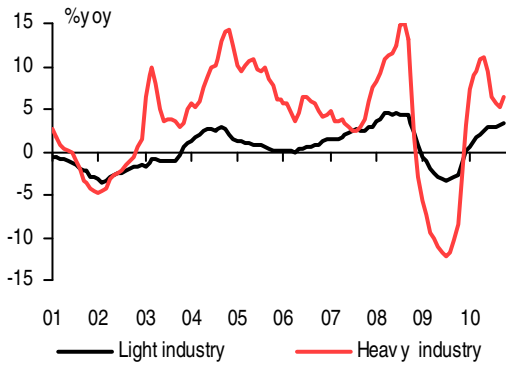
Source: CEIC, HSBC

4. Producer price index



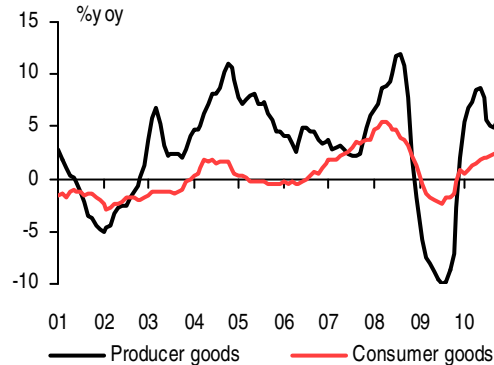
Source: CEIC, HSBC

5. PPI by industry (1)



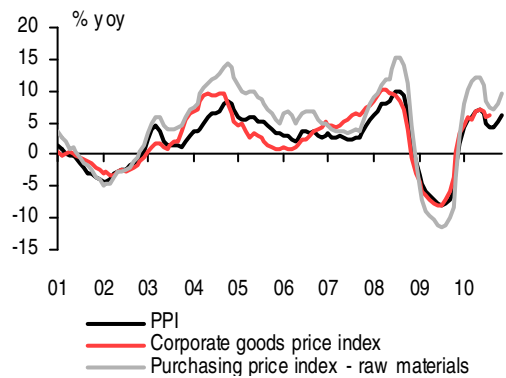
Source: CEIC, HSBC

6. PPI by industry (2)



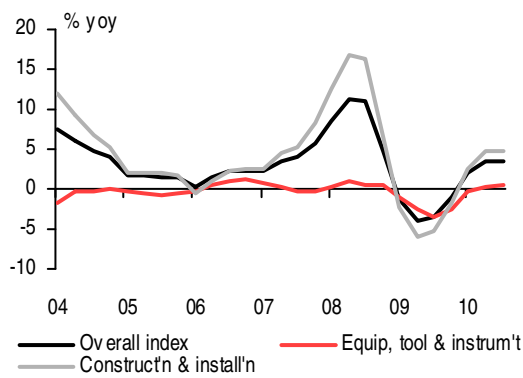
Source: CEIC, HSBC

7. Purchase and output prices



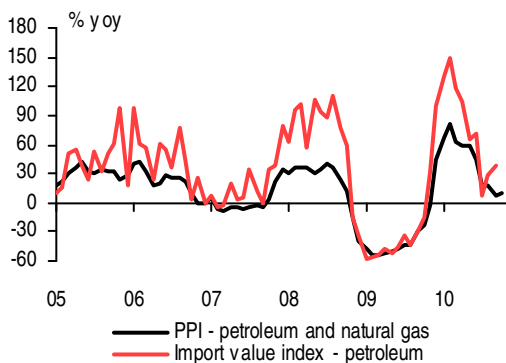
Source: CEIC, HSBC

8. Fixed asset investment price index



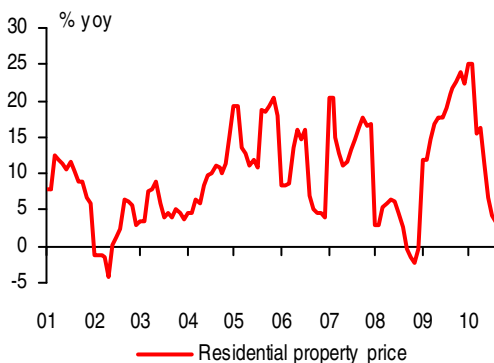
Source: CEIC, HSBC

9. Petroleum prices



Source: CEIC, HSBC

10. Property prices

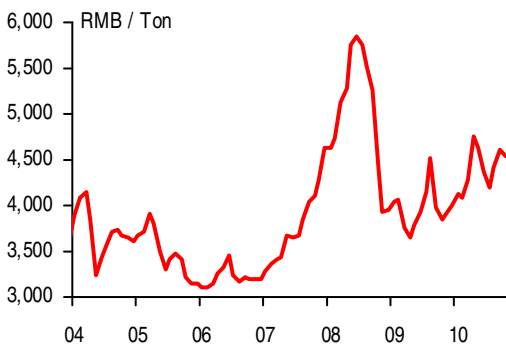


Source: CEIC, HSBC

Commodity prices

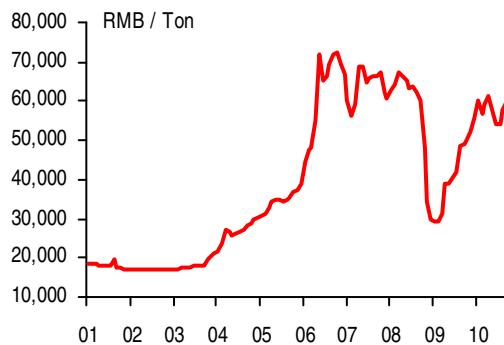
- ▶ PPI rebounded further to 6.1% y-o-y in November from 5% y-o-y in October...
- ▶ ...consistent with the acceleration in input price components in HSBC China PMI readings
- ▶ The rally in international commodities prices against the Fed's QE2 is likely to be the main driver

1. Wholesale price: Whorl steel



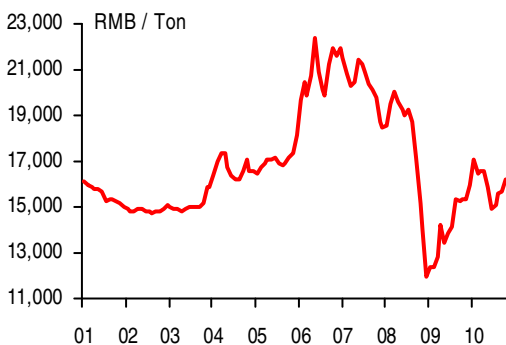
Source: CEIC, HSBC

2. Wholesale price: Electrolyse copper



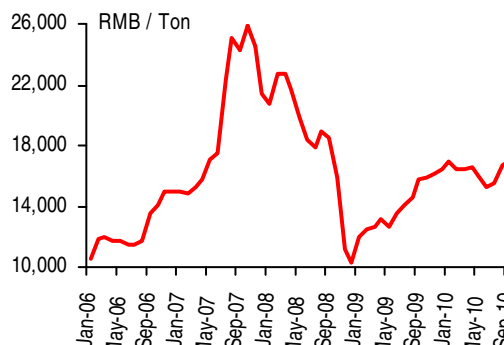
Source: CEIC, HSBC

3. Wholesale price: Aluminium



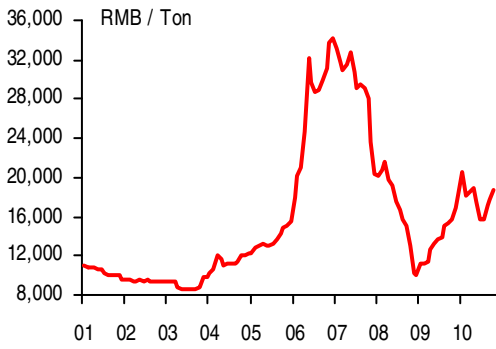
Source: CEIC, HSBC

4. Wholesale price: Lead



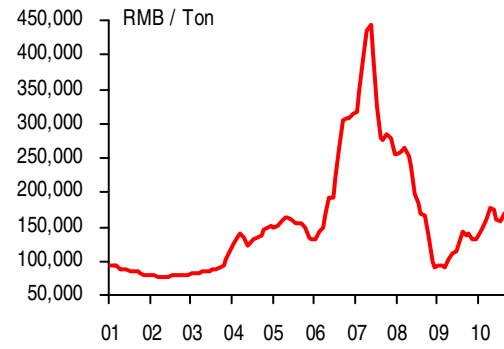
Source: CEIC, HSBC

5. Wholesale price: Zinc



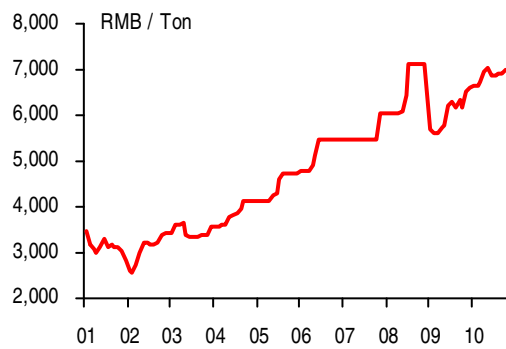
Source: CEIC, HSBC

6. Wholesale price: Nickel



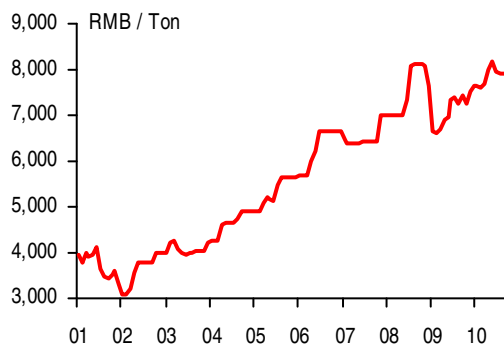
Source: CEIC, HSBC

7. Wholesale price: Diesel oil



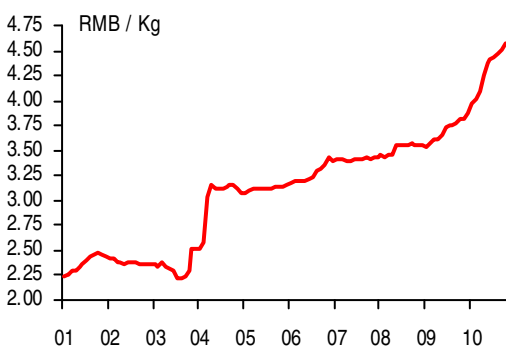
Source: CEIC, HSBC

8. Wholesale price: Gasoline



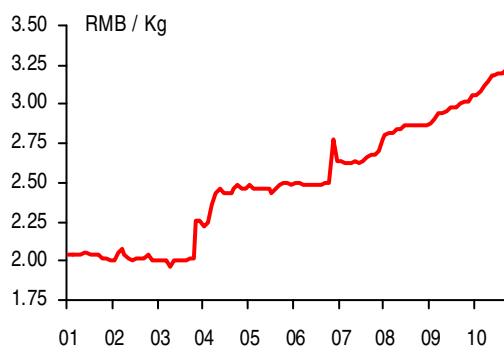
Source: CEIC, HSBC

9. Retail price: Rice



Source: CEIC, HSBC

10. Retail price: Flour

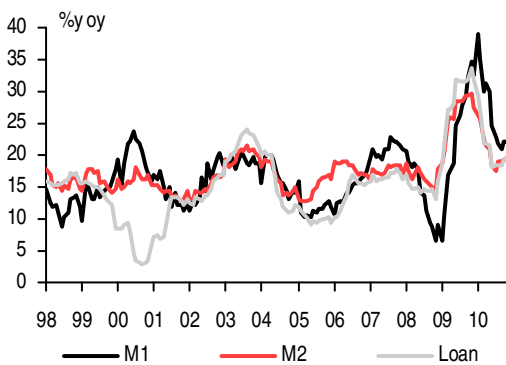


Source: CEIC, HSBC

Money and credit growth

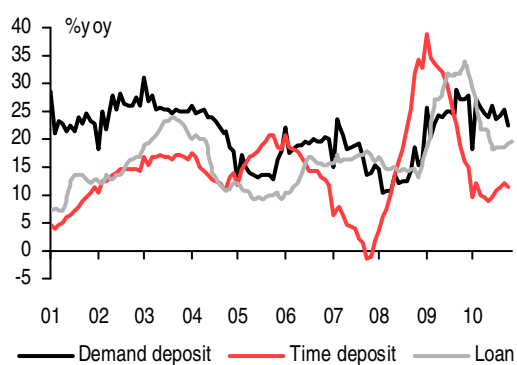
- ▶ Despite two reserve ratio hikes in November, new bank lending continued to surprise on the upside at RMB564bn, almost exhausting the RMB7.5trn annual quota
- ▶ As a result, loan growth picked up to 19.8% y-o-y from 19.3% and broad money supply growth rebounded to 19.5% from 19.3% y-o-y, above the 17% year-end target
- ▶ We expect a lower money supply and credit growth target for next year to check inflation and control liquidity

1. Loans vs money supply



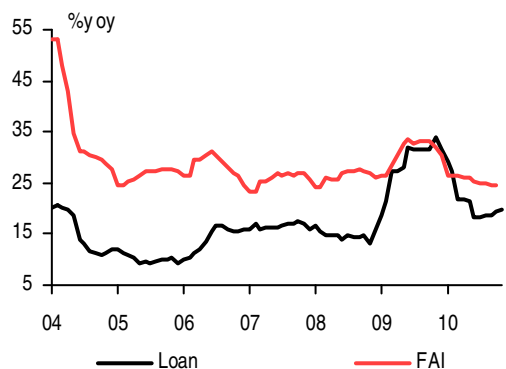
Source: CEIC, HSBC

2. Deposits vs loan growth



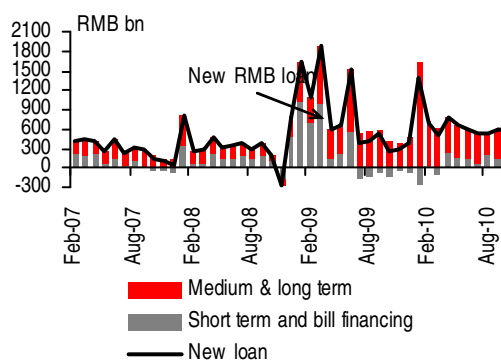
Source: CEIC, HSBC

3. FAI vs loan growth



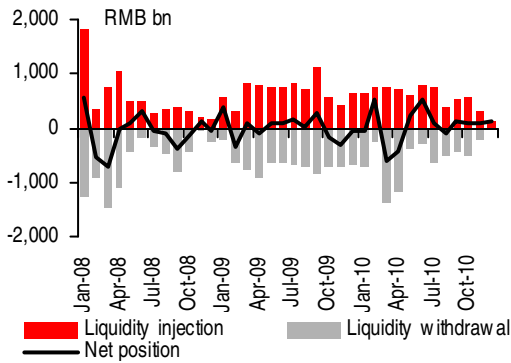
Source: CEIC, HSBC

4. New renminbi loans



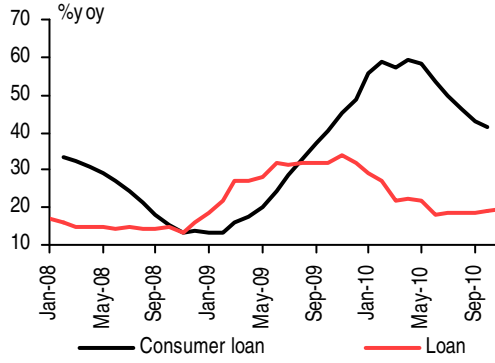
Source: CEIC, HSBC

5. PBoC open market operations



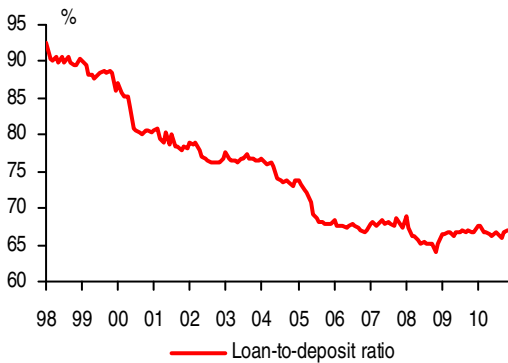
Source: Wind, HSBC (Data up to 16 Dec 2010)

6. Consumer credit



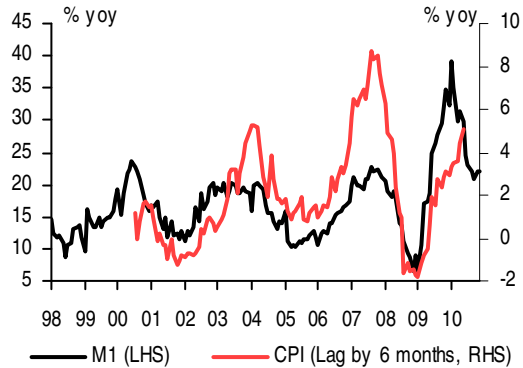
Source: CEIC, HSBC

7. Loan-to-deposit ratio



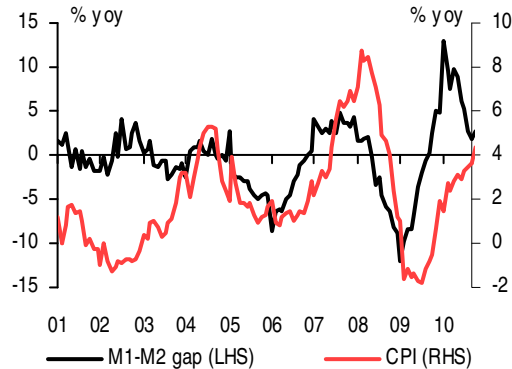
Source: CEIC, HSBC

8. Money supply vs price level



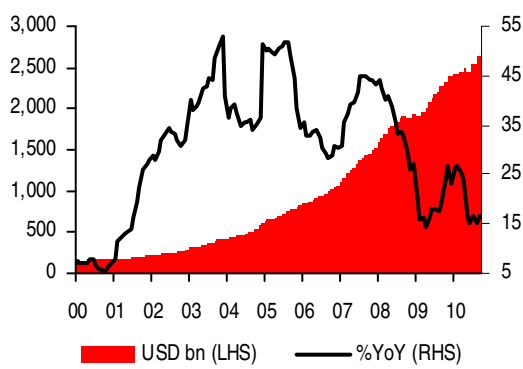
Source: CEIC, HSBC

9. M1-M2 gap vs CPI



Source: CEIC, HSBC

10. Foreign reserves

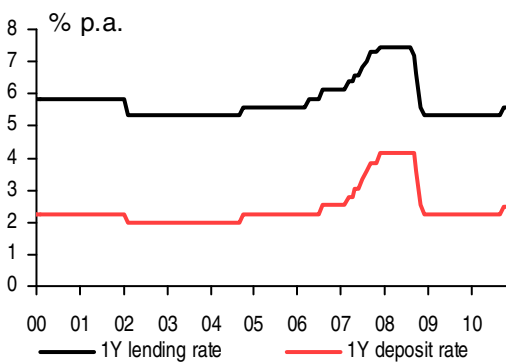


Source: CEIC, HSBC

Interest and exchange rates

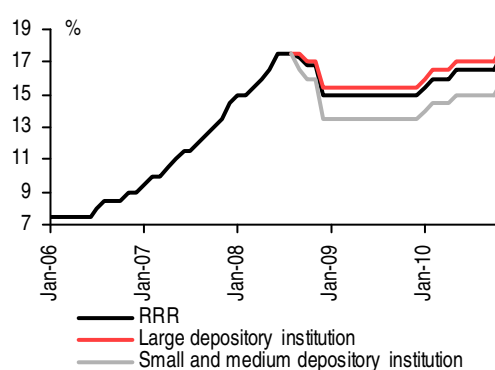
- ▶ Following the PBoC's 25bp interest rate hike in October, the market has priced in more hikes as reflected in higher yields
- ▶ Inflation and growth surprises in November imply more immediate tightening; we expect three 25bp rate hikes by end 2011
- ▶ RMB has appreciated against USD by 3% since the June de-peg, but appreciation has little impact on curbing inflation

1. Lending vs savings rates



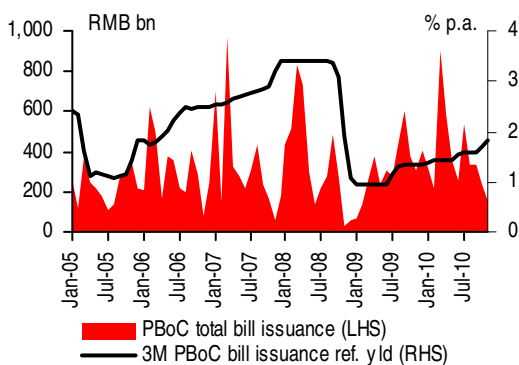
Source: CEIC, HSBC

2. Required reserve ratio



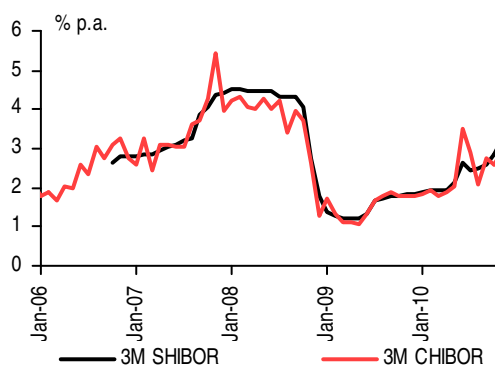
Source: CEIC, HSBC

3. PBoC bill issuance and reference yield



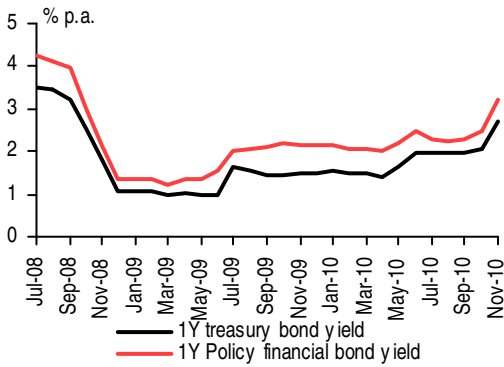
Source: CEIC, HSBC

4. Interbank rate



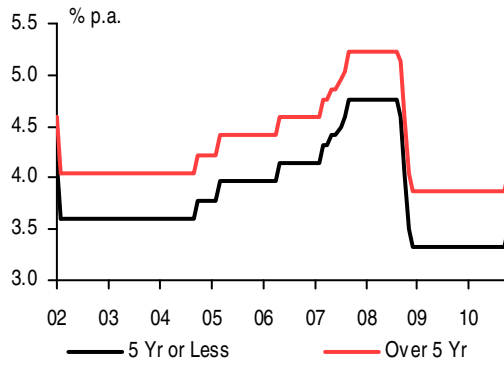
Source: CEIC, HSBC

5. Bond yields



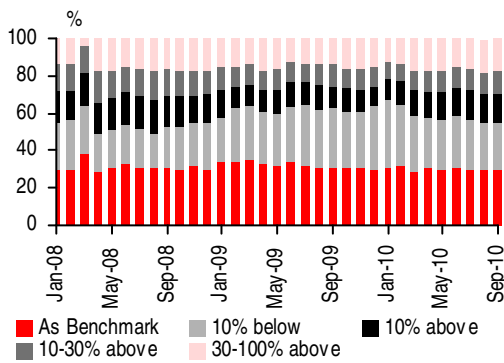
Source: CEIC, HSBC

6. Mortgage rate



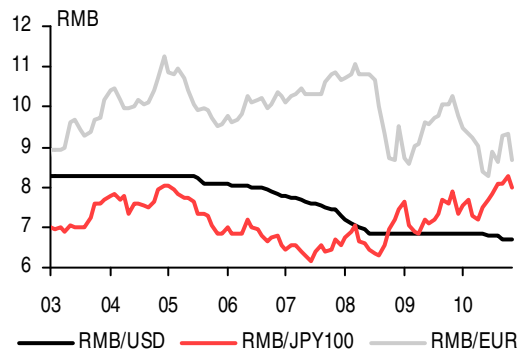
Source: CEIC, HSBC

7. Distribution of actual lending rate



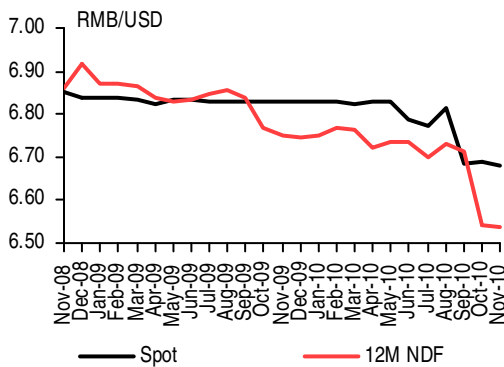
Source: CEIC, HSBC

8. Foreign exchange rate



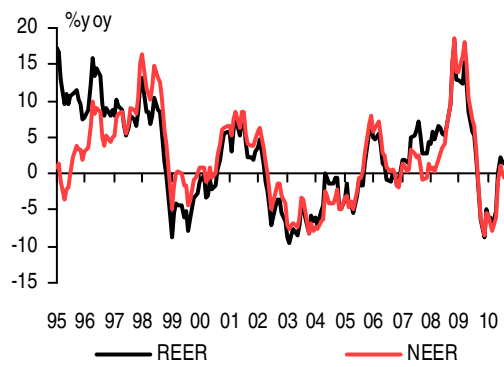
Source: CEIC, HSBC

9. RMB spot vs forward rate



Source: CEIC, HSBC

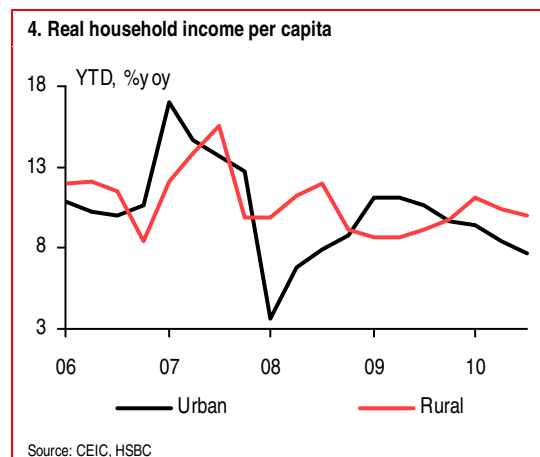
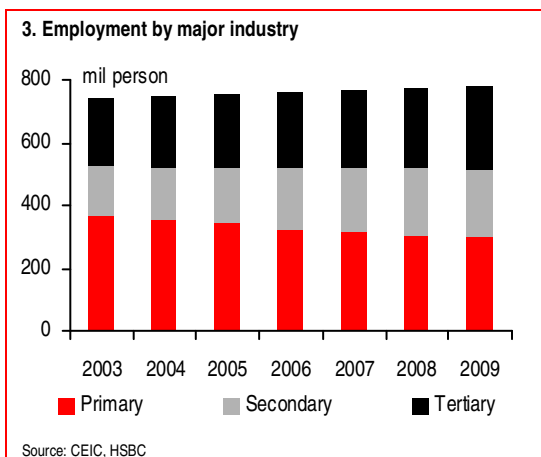
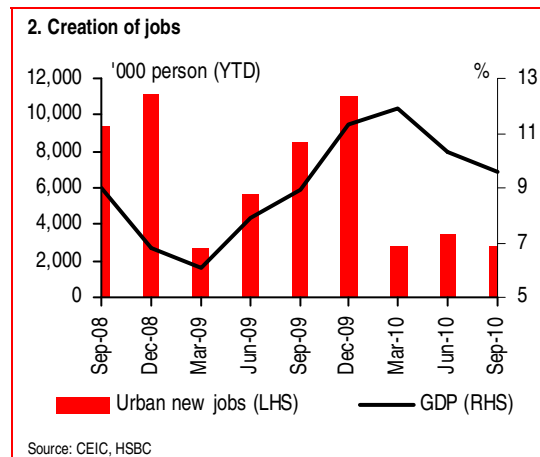
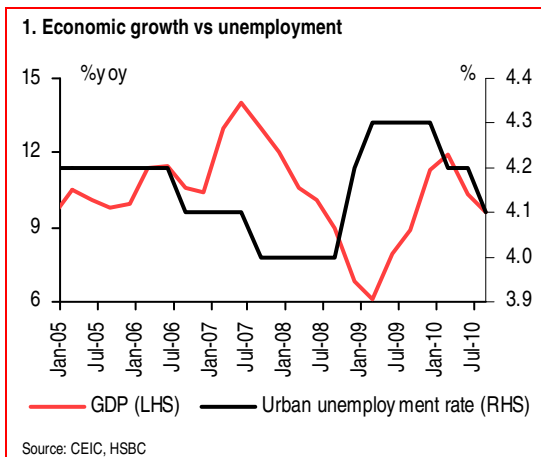
10. Effective exchange rate



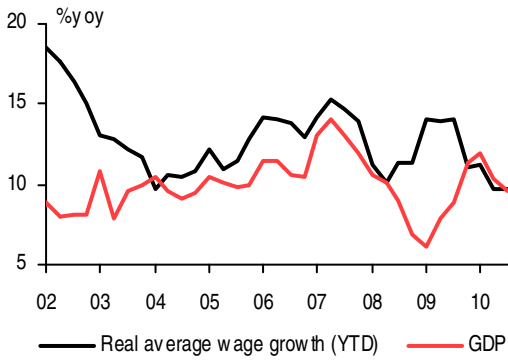
Source: CEIC, HSBC

Employment and income

- ▶ The labour market saw continuous improvement as reflected in expansion in the employment components of HSBC China manufacturing and services PMI readings
- ▶ The official urban registered unemployment rate fell from 4.3% at end 2009 to 4.1% end 3Q, close to the pre-financial crisis level
- ▶ Household income growth has been steady, with urban household income up 7.5% y-o-y and rural income rising to 9.7% y-o-y in the first three quarters in real terms

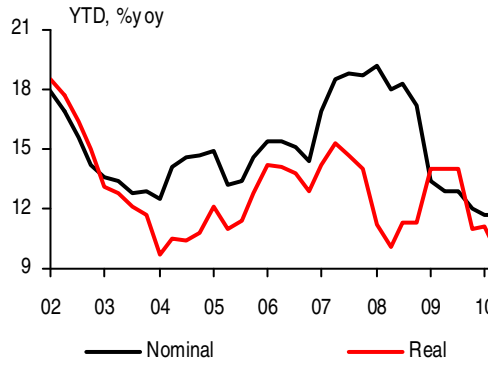


5. Economic growth vs real wage growth



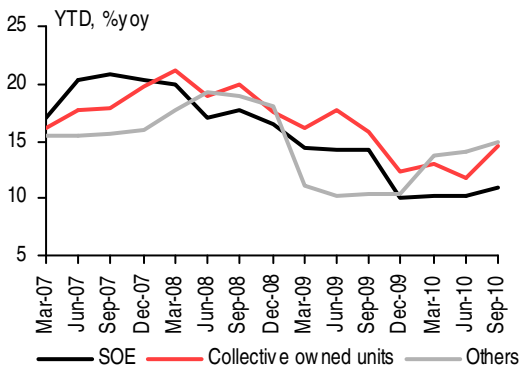
Source: CEIC, HSBC

6. Average wage growth



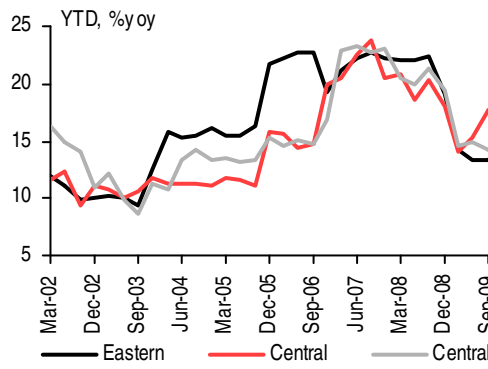
Source: CEIC, HSBC

7. Wage growth by enterprise



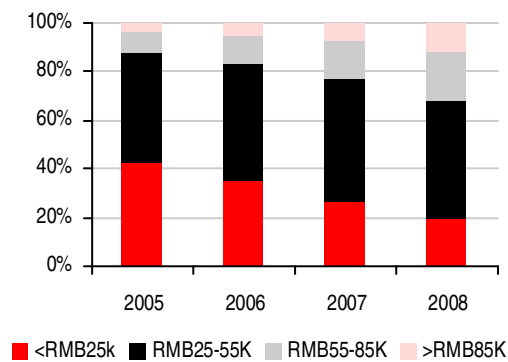
Source: CEIC, HSBC

8. Wage growth by region



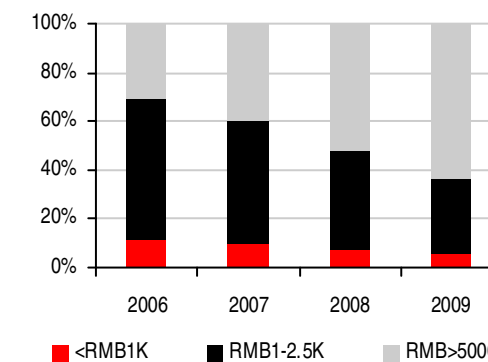
Source: CEIC, HSBC

9. Household income distribution – Urban



Source: CEIC, HSBC

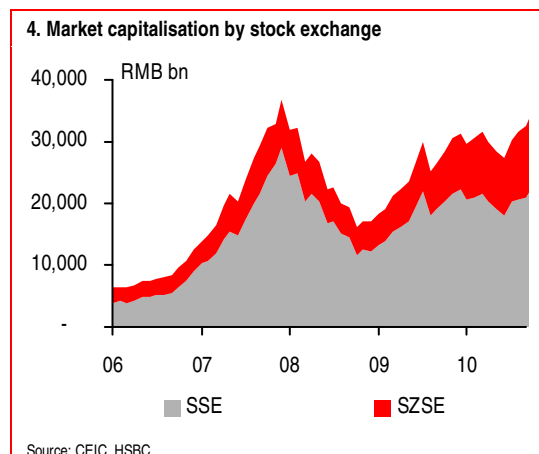
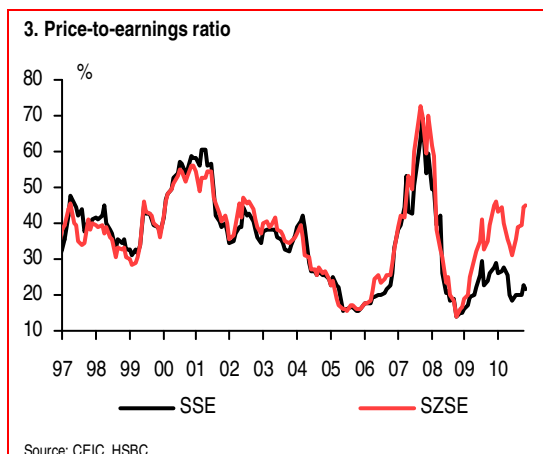
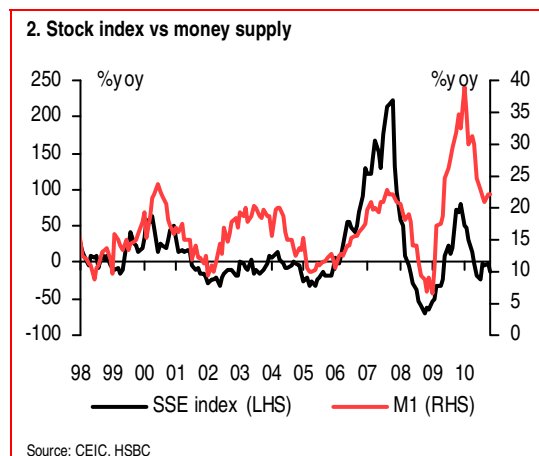
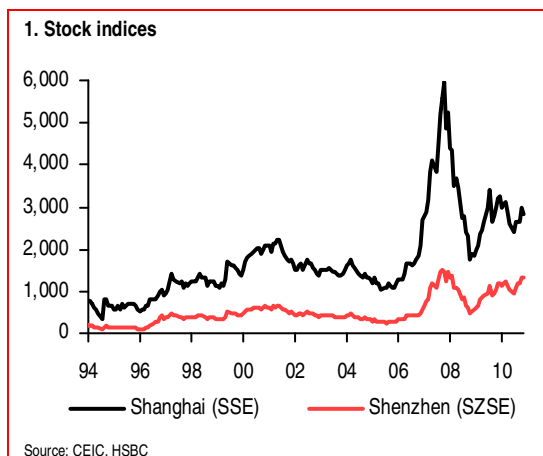
10. Household income distribution – Rural



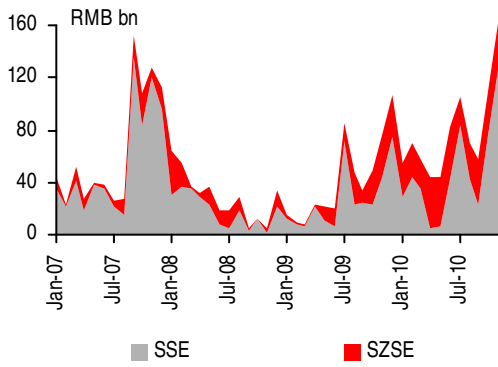
Source: CEIC, HSBC

Asset markets

- ▶ Amid a rebound in property sales, November property prices rose 0.3% m-o-m, inviting market speculation about tougher tightening
- ▶ Property tightening should stay in place through 2011 and this will also help deter speculative money inflows
- ▶ Further strengthening of stock-trading income tax collection and expectations of imminent rate hike weigh on the stock market; HSBC's equity strategist expects SHCOMP at 2,800 at year-end

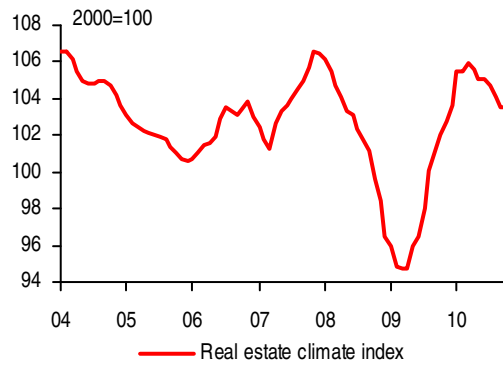


5. Capital raised by stock exchange



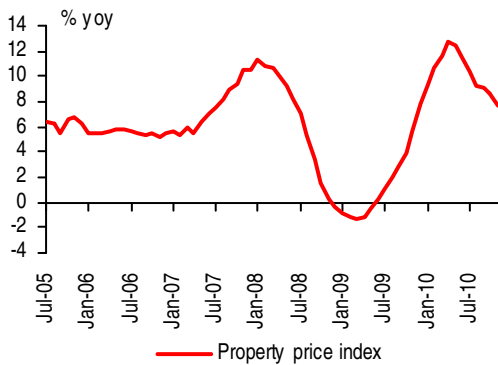
Source: CEIC, HSBC

6. Real estate index



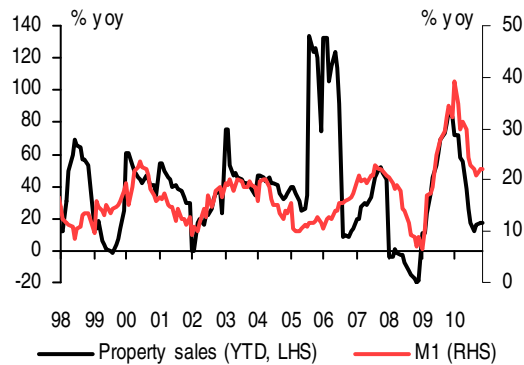
Source: CEIC, HSBC

7. Property prices



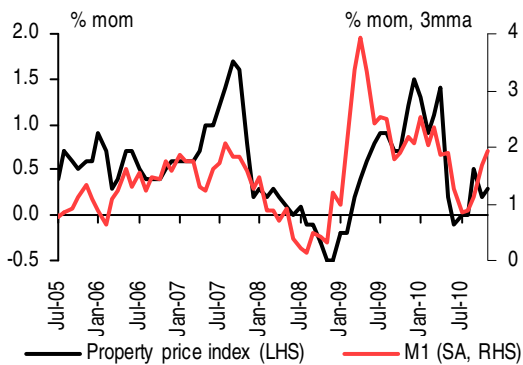
Source: CEIC, HSBC

8. Property sales vs money supply



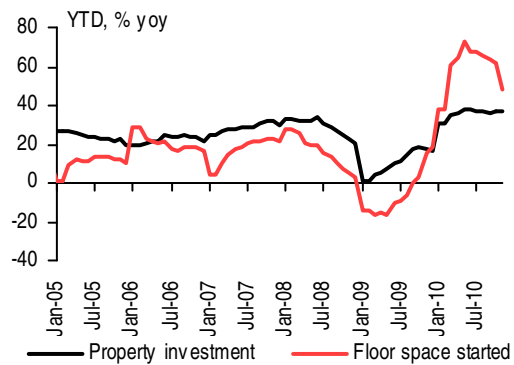
Source: CEIC, HSBC

9. Property prices vs money supply



Source: CEIC, HSBC

10. Property investment vs property started



Source: CEIC, HSBC

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Data and forecasts

China

Macro framework

	2005	2006	2007	2008	2009	2010e	2011e
Production, demand and employment							
GDP growth (% y-o-y)	10.2	11.6	13	9.6	9.1	10.0	8.9
Nominal GDP (USDbn)	2,239	2,661	3,386	4,524	4,913	5,631	6,531
GDP per capita (USD)	1,723	2,035	2,576	3,424	3,699	4,219	4,869
Nominal retail sales (% y-o-y)	12.9	13.7	16.8	21.6	15.5	18.5	19
Fixed asset investment (nominal, % y-o-y)	27.2	24.5	25.8	26.1	30.5	25.0	21.5
Industrial production (excl. small enterprises % y-o-y)	15.9	16.2	16.0	12.9	12.9	15.5	13.3
Gross domestic saving (% GDP)	48.2	50.1	51.0	51.4	50.0	50.5	50.0
Unemployment rate, average (%)	4.2	4.1	4.0	4.2	4.3	4.3	4.3
Prices & wages							
CPI, average (% y-o-y)	1.8	1.5	4.8	5.9	-0.7	3.3	3.9
CPI, end-year (% y-o-y)	1.6	2.8	6.5	1.2	1.9	4.6	2.2
PPI, end-year (% y-o-y)	3.2	3.1	5.4	-1.1	1.7	5	5.8
Manufacturing wages, nominal (% y-o-y)	12.3	14.0	16.2	17.0	9.0	13.0	13
Money, FX & interest rates							
Central bank money M0, average (%)	9.9	13.2	13.6	12.4	12.1	11.0	11.0
Broad money supply M2, average (%)	16.0	18.1	17.5	16.7	26.5	23.3	17.5
Policy rate, end-year (%)	5.58	6.12	7.47	5.31	5.31	5.81	6.31
5yr yield, end-year (%)	5.85	6.48	7.74	5.76	5.76	6.16	6.56
RMB /USD, end-year	8.07	7.81	7.30	6.82	6.83	6.67	6.54
RMB /USD, average	8.18	7.96	7.60	6.94	6.83	6.77	6.60
RMB /EUR, end-year	9.52	10.3	10.66	9.48	9.77	9.00	8.83
RMB /EUR, average	10.19	10.01	10.56	10.11	9.54	8.81	8.91
External sector							
Merchandise exports (USDbn)	762	969	1,219	1,429	1,202	1,574	1,858
Merchandise imports (USDbn)	660	792	956	1,133	1,006	1,398	1,677
Trade balance (USDbn)	102	178	263	296	196	176.5	180.3
Current account balance (USDbn)	161	253	372	426	284	250	260
Current account balance (% GDP)	7.2	9.5	11.0	9.4	5.8	4.4	4.0
Net FDI (USDbn)	72	73	84	108	90	86	99
Net FDI (% GDP)	3.2	2.7	2.5	2.4	1.8	1.5	1.5
Current account balance plus FDI (% GDP)	10.4	12.2	13.4	11.8	7.6	5.9	5.4
Exports (% y-o-y)	28.4	27.2	25.8	17.2	-15.9	31.0	18.0
Imports (% y-o-y)	17.6	19.9	20.8	18.5	-11.3	39.0	20.0
International FX reserves (USDbn)	819	1,066	1,528	1,946	2,399	2,550	2,700
Import cover (months)	13.8	15.0	17.7	18.9	27.9	22.1	20.4
Public and external solvency indicators							
Commercial banks' FX assets (USDbn)	169	200	188	181	212	245	292
Gross external debt (USDbn)	281	323	374	375	350	330	360
Short term external debt (% of int'l reserves)	19.1	17.2	14.4	10.8	6.3	4.7	4.8
Consolidated government balance (% GDP)	-1.2	-1.0	0.6	-0.4	-2.2	-2.8	-2.5

Source: HSBC

Global

Key forecasts

	GDP				Inflation			
	2008	2009	2010e	2011e	2008	2009	2010e	2011e
World (nominal GDP weights)	-2.2	3.5	2.9	3.3	1.0	2.3	2.2	2.2
World (PPP weights)	-0.5	4.8	4.0	4.2	1.9	3.2	2.8	2.8
Developed	-3.5	2.4	1.8	2.3	0.0	1.3	1.2	1.2
Emerging	1.9	7.2	6.2	6.2	4.7	5.6	5.4	5.3
North America	-2.6	2.8	2.4	3.2	-0.3	1.6	1.0	1.1
US	-2.6	2.7	2.5	3.2	-0.3	1.6	0.9	1.1
Canada	-2.5	3.1	2.1	2.3	0.3	1.7	1.6	2.0
Latin America	-3.4	6.0	4.5	4.6	6.2	7.7	7.6	6.9
Mexico	-6.5	4.3	3.8	4.5	5.3	4.2	4.0	3.4
Brazil	-0.2	7.5	5.1	4.5	4.9	4.9	5.4	4.6
Argentina	-2.7	7.8	4.5	5.0	14.8	26.5	21.7	18.7
Chile	-1.5	5.0	5.5	4.5	0.3	1.6	3.3	3.2
Western Europe	-4.1	1.6	1.3	1.6	0.6	1.8	1.8	1.7
Euro-15	-4.0	1.6	1.3	1.6	0.3	1.6	1.6	1.7
Germany	-4.7	3.3	1.9	1.8	0.2	1.1	1.2	1.3
France	-2.5	1.6	1.5	1.8	0.1	1.8	1.8	1.6
Italy	-5.1	1.0	0.7	1.0	0.8	1.6	1.9	1.7
Spain	-3.7	-0.4	0.6	1.5	-0.2	1.6	1.5	1.7
Other Western Europe	-4.3	1.7	1.5	1.8	1.5	2.4	2.3	1.8
UK	-4.9	1.4	1.4	1.8	2.2	3.2	2.9	1.8
Norway	-1.3	0.5	1.4	2.1	2.2	2.3	1.7	2.5
Sweden	-5.1	4.0	2.9	2.5	-0.3	1.1	2.1	2.5
Switzerland	-1.9	2.9	1.7	1.8	-0.5	0.7	0.7	1.5
EMEA	-3.4	3.8	3.8	3.8	7.4	5.9	6.8	6.7
Czech Republic	-4.0	2.1	2.7	2.8	1.0	1.5	2.4	2.4
Hungary	-6.2	1.0	2.7	3.0	4.2	4.8	3.2	3.4
Poland	1.8	3.2	3.9	3.4	3.5	2.5	2.9	3.3
Russia	-7.9	3.8	3.5	3.0	11.7	7.0	9.5	8.5
Turkey	-4.7	6.8	3.9	4.3	6.3	8.7	7.7	7.0
Ukraine	-15.1	5.5	4.0	5.1	16.0	8.5	8.4	9.0
Egypt*	4.7	5.1	6.0	6.1	10.0	10.7	10.4	11.0
Israel	0.7	3.9	3.4	3.6	3.9	2.3	3.0	2.7
Saudi Arabia	0.1	3.6	4.4	4.8	5.1	5.5	6.6	7.0
UAE	-2.9	2.0	3.9	4.5	1.8	1.0	2.7	4.0
South Africa	-1.8	2.6	3.5	3.1	7.2	4.7	5.5	6.0
Asia-Pacific	0.7	6.1	4.7	5.0	0.8	2.0	1.8	2.0
Japan	-5.2	3.0	0.7	1.5	-1.3	-1.1	-0.5	-0.4
Australia	1.2	3.4	4.1	3.9	1.8	3.0	3.1	2.9
New Zealand	-0.5	1.4	2.6	3.7	2.1	2.3	4.0	2.3
Asia ex Japan	5.7	8.8	7.6	7.4	2.6	4.6	3.7	3.8
China	9.1	10.0	8.9	8.6	-0.7	3.2	3.9	2.9
Asia ex Japan & China	2.4	7.4	6.1	6.1	5.1	5.8	4.4	4.9
Hong Kong	-2.8	5.4	4.7	4.5	0.6	2.4	2.9	3.3
India	6.7	8.8	8.6	8.0	10.9	10.7	5.4	7.1
Indonesia	4.5	6.1	6.4	6.3	4.8	5.2	6.0	5.2
Malaysia	-1.7	7.3	5.2	5.0	0.6	1.9	2.7	2.2
Philippines	1.1	5.9	4.6	5.6	3.3	4.2	4.5	4.7
Singapore	-1.3	13.2	4.6	6.0	0.6	2.2	2.7	2.8
South Korea	0.2	6.0	4.0	4.6	2.8	2.7	2.9	3.0
Taiwan	-1.9	7.3	4.9	3.8	-0.9	1.2	1.6	1.6
Thailand	-2.2	7.9	5.3	4.1	-0.8	3.5	3.6	3.0
Vietnam	5.3	7.0	7.5	7.8	7.1	8.7	8.5	8.0

Notes: Calendar year; except for * which is based on Egyptian fiscal year (July-June); global and regional aggregates are calculated using chain nominal GDP (USD) weights.
Source: HSBC

Notes

Notes

Disclosure appendix

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- 2 All market data included in this report are dated as at close 15 December 2010, unless otherwise indicated in the report.
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Issuer of report

The Hongkong and Shanghai Banking Corporation Limited

Level 19, 1 Queen's Road Central

Hong Kong SAR

Telephone: +852 2843 9111

Telex: 75100 CAPEL HX

Fax: +852 2801 4138

Website: www.research.hsbc.com

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Global Economics Research Team

Global

Stephen King
Global Head of Economics
+44 20 7991 6700 stephen.king@hsbcib.com

Karen Ward
Senior Global Economist
+44 20 7991 3692 karen.ward@hsbcib.com

Madhur Jha
+44 20 7991 6755 madhur.jha@hsbcib.com

Europe

Janet Henry
Chief European Economist
+44 20 7991 6711 janet.henry@hsbcib.com

Astrid Schilo
+44 20 7991 6708 astrid.schilo@hsbcib.com

Germany
Lothar Hessler
+49 21 1910 2906 lothar.hessler@hsbctrinkaus.de

France
Mathilde Lemoine
+33 1 4070 3266 mathilde.lemoine@hsbc.fr

United Kingdom
Stuart Green
+44 20 7991 6718 stuart1.green@hsbcib.com

Andrew Grantham
+44 20 7991 2170 andrew.grantham@hsbcib.com

North America

Kevin Logan
+1 212 525 3195 kevin.r.logan@us.hsbc.com

Ryan Wang
+1 212 525 3181 ryan.wang@us.hsbc.com

Stewart Hall
+1 416 868 7523 stewart_hall@hsbc.ca

Asia Pacific

Qu Hongbin
Managing Director, Co-head Asian Economics Research and Chief Economist Greater China
+852 2822 2025 hongbinqu@hsbc.com.hk

Frederic Neumann
Managing Director, Co-head Asian Economics Research
+852 2822 4556 fredericneumann@hsbc.com.hk

Leif Eskesen
Chief Economist, India & ASEAN
+65 6239 0840 leifeskesen@hsbc.com.sg

Paul Bloxham
Chief Economist, Australia and New Zealand
+61 2925 52635 paulbloxham@hsbc.com.au

Song Yi Kim
+852 2822 4870 songyikim@hsbc.com.hk

Donna Kwok
+852 2996 6621 donnahjkwok@hsbc.com.hk

Sherman Chan
+852 2996 6975 shermanwkchan@hsbc.com.hk

Wellian Wiranto
+65 6230 2879 wellianwiranto@hsbc.com.sg

Seiji Shiraishi
+81 3 5203 3802 seiji.shiraishi@hsbc.co.jp

Yukiko Tani
+81 3 5203 3827 yukiko.tani@hsbc.co.jp

Sun Junwei
Associate

Sophia Ma
Associate

Emerging Europe, Middle East and Africa

Alexander Morozov
+7 495 783 8855 alexander.morozov@hsbc.com

Murat Ulgen
+90 212 376 4619 muratulgen@hsbc.com.tr

Simon Williams
+971 4 507 7614 simon.williams@hsbc.com

Liz Martins
+971 4 423 6928 liz.martins@hsbc.com

Latin America

Argentina
Javier Finkman
Chief Economist, South America ex-Brazil
+54 11 4344 8144 javier.finkman@hsbc.com.ar

Ramiro D Blazquez
Senior Economist
+54 11 4348 5759 ramiro.blazquez@hsbc.com.ar

Jorge Morgenstern
Economist
+54 11 4130 9229 jorge.morgenstern@hsbc.com.ar

Brazil
Andre Loes
Chief Economist
+55 11 3371 8184 andre.a.loes@hsbc.com.br

Constantin Jancso
Senior Economist
+55 11 3371 8183 constantin.c.jancso@hsbc.com.br

Marcos Fernandes
+55 11 6847 9787 marcos.r.fernandes@hsbc.com.br

Mexico
Sergio Martin
Chief Economist
+52 55 5721 2164 sergio.martinm@hsbc.com.mx

Central America
Lorena Dominguez
Economist
+52 55 5721 2172 lorena.dominguez@hsbc.com.mx